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Supreme Court of the United States

ASWORTH, LLC (f/k/a Asworth Corporation); HTF, LLC (f/k/a HT-Forum, Inc.); and D AVIATION SERVICES, LLC (f/k/a D Aviation Services, Inc.)

Petitioners,

v.

DEPARTMENT OF REVENUE, FINANCE AND ADMINISTRATION CABINET, COMMONWEALTH OF KENTUCKY (f/k/a Revenue Cabinet, Commonwealth of Kentucky)

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE KENTUCKY COURT OF APPEALS

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether a State violates the Commerce Clause of the U.S. Constitution by subjecting an out-of-state corporate partner to income tax when the partner has no property or employees in the State and the partner's only connection with the State is the holding of passive investment interests in entities that have in-state business operations?

2. Whether a State violates the Due Process Clause of the U.S. Constitution by enacting non-curative tax legislation that retrospectively denies interest on overpayments of court-ordered tax refunds on a retroactive basis of up to 17 years?

RULE 29.6 STATEMENT

Asworth, LLC, formerly known as Asworth Corporation ("Asworth"), does not have a parent corporation nor any publicly held corporation that owns 10% or more of its stock.

HTF, LLC, formerly known as HT-Forum, Inc. ("HTF"), does not have a parent corporation nor any publicly held corporation that owns 10% or more of its stock.

D Aviation Services, LLC, formerly known as D Aviation Services, Inc. ("D Aviation"), does not have a parent corporation nor any publicly held corporation that owns 10% or more of its stock.

HTF and D Aviation are both 100% owned by Asworth.

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PETITION FOR A WRIT OF CERTIORARI

Petitioners respectfully petition this Court for a Writ of Certiorari to review the Opinion of the Kentucky Court of Appeals rendered on November 20, 2009.

OPINIONS BELOW

The Opinion of the Kentucky Court of Appeals is unreported and is reprinted in its entirety in Petitioners' Appendix ("Pet. App."). The Supreme Court of Kentucky's Order of August 18, 2010 denying Petitioners' Motion for Discretionary Review is also unreported and is reprinted at Pet. App. 46a. The Order of the Franklin Circuit Court is also unreported and is reprinted at Pet. App. 34a. The Order of the Kentucky Board of Tax Appeals is likewise unreported and is reprinted at Pet. App. 27a.

JURISDICTION

The Opinion for which certiorari is sought, issued by the Kentucky Court of Appeals, was rendered on November 20, 2009. Pet. App. 1a. Petitioners timely filed a Motion for Discretionary Review with the Supreme Court of Kentucky on December 18, 2009, which was denied on August 18, 2010. Pet. App. 46a. This Court has jurisdiction pursuant to 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The constitutional provisions involved are the Commerce and the Due Process Clauses of the U.S. Constitution.

The Commerce Clause provides: "the Congress shall have Power . . . To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." U.S. CONST. art. I, § 8.

The Due Process Clause of the Fourteenth Amendment to the U.S. Constitution provides, in pertinent part: "[N]or shall any state deprive any person of life, liberty, or property, without due process of law." U.S. CONST. amend. XIV, § 1.

The Kentucky statutory provisions involved in this case are set forth at Pet. App. 47a, all of which are subservient to the constitutional sections cited here.

INTRODUCTION

A. Physical Presence – *Quill Corp. v. North Dakota*

This Petition for a Writ of Certiorari presents the important question of whether the Commerce Clause permits a state to impose income tax on an out-of-state corporate partner having no in-state physical presence, for no reason other than it is a passive investor in an entity that does business in the taxing state. For nearly 20 years, this question has been litigated in countless forums with conflicting outcomes. This Court should intervene to address whether states have the power and authority to reach across jurisdictional lines and subject out-of-state corporate partners to taxation when they maintain no property or employees in the taxing jurisdiction. This issue is as fundamental as the Commerce Clause and is of pressing significance to American business.

Many states are exceeding the constitutional limits of power as set forth in the Commerce Clause and as proclaimed by this Court, holding that physical presence is not a predicate to taxing income, in plain violation of this Court's holdings in *Nat'l Bellas Hess, Inc. v. Dep't of Revenue of Illinois*, 386 U.S. 753 (1967) and *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). Other states are following these dictates and the decisions of this Court, correctly holding that physical presence is required before states may subject out-of-state companies to income tax.

This issue has been litigated in appellate courts of at least 20 states and many lower forums with conflicting results. Simply put, the courts are in a state of chaos on whether physical presence is required as a constitutional predicate prior to taxation. Some courts, such as the court below in this case, have held that out-of-state partners are subject to state income taxation based solely on the holding of passive investment interests, even in the face of the partner having no physical presence in the taxing state. Other states have held to the contrary. Further, at least 35 states have enacted legislation, regulations or policies applying what state tax expert Professor Richard D. Pomp has referred to as a "metaphysical presence" test in income tax settings and stating that holding a partnership interest alone creates tax nexus. Many states are thus flouting this Court's physical presence requirement in *Quill*.

Beyond Kentucky, the lower court's decision will have significant impact on tax administration and enforcement in every state. The detrimental effect of

the decision affects corporate taxpayers since it wrongly preempts and substitutes this Court's Commerce Clause "physical presence" standard with a Due Process "protection and benefits" standard. This Court's intervention is necessary to ensure that taxpayers, legislators, and administrators are appropriately advised regarding the valid constitutional parameters of state tax nexus or jurisdictional authority to tax. If not, and were the lower court's decision left to stand, virtually every out-of-state taxpayer receiving investment income from a company operating in another state will now be subject to that state's taxation.

As Justice White accurately predicted, it was a "sure bet" that the "vagaries of 'physical presence'" and the scope of the *Quill* Opinion "will be tested to their fullest in our courts." *Quill*, 504 U.S. at 331 (White, J., concurring in part and dissenting in part). As the *Quill* majority admitted, "our law in this area is something of a 'quagmire' and the 'application of constitutional principles to specific state statutes leaves much room for controversy and confusion and little in the way of precise guides to the states in the exercise of their indispensable power of taxation.'" *Quill*, 504 U.S. at 315-16. The avalanche of litigation on whether the physical presence rule governs income taxes or only sales and use taxes, post-*Quill*, demonstrates intervention is needed.

Many states, including Tennessee, Texas and Michigan, correctly analyzed *Quill* and held that this Court's affirmation of the physical presence rule in the sales and use tax setting did not equate to a rejection of that rule in other state tax (*e.g.*, income tax) settings.

Accordingly, these states held that non-resident companies with no in-state property, representatives or employees were not subject to state income or franchise taxes.

However, other states have misread *Quill*, holding that the physical presence rule is limited to sales and use taxes and does not apply to income taxes or other taxes. Tellingly, most states that upheld non-sales and use taxation without physical presence did so in cases involving companies that licensed intellectual property for in-state use by related companies, which raised the specter of sham transactions, no business purpose, and other common law doctrines. These cases are distinguishable from the instant situation, which involves no intangible property in Kentucky.

The lower court's decision in this case demonstrates that the departure from the physical presence rule is not limited to those types of cases; it is now being applied to traditional investment relationships. The lower court specifically recognized from the stipulated facts that Petitioners maintained no Kentucky property or employees — their sole connection with Kentucky was the receipt of passive investment income from non-Kentucky entities doing business there. Pet. App. 2a. This notwithstanding, the lower court questioned whether *Quill's* physical presence standard applies in the income tax context, concluding it "is unclear," and ruled that Petitioners' receipt of income from investments in entities with Kentucky operations was sufficient to meet substantial nexus under the Commerce Clause, *merely because the entities [not Petitioners] received protection and benefits from Kentucky*. Pet. App. 11a.

The lower court plainly erred by substituting this Court's Commerce Clause "substantial nexus" standard with the "purposeful availment" standard that defines the Due Process Clause so-called, "minimum contacts." *See Burger King Corp. v. Rudzewicz*, 471 U.S. 462 (1985). As this Court reiterated in *Quill*, the Commerce Clause's limits on state taxation are more restrictive than the "minimum contacts" needed to support personal jurisdiction under the Due Process Clause and are "animated by different constitutional concerns and policies." *Quill*, 504 U.S. at 312-13. As well-reminded in *Quill*, ". . . a corporation may have the 'minimum contacts' with a taxing State as required by the Due Process Clause, and yet lack the 'substantial nexus' with that State as required by the Commerce Clause." *Id.* at 313.

Here, the lower court relied solely upon an erroneous decision from an intermediate appellate court in Illinois holding that out-of-state limited partners are subject to income tax on income received from investments in in-state partnerships, despite having no actual physical presence in Illinois. *See Borden Chemicals and Plastics, LP v. Zehnder*, 726 N.E.2d 73 (Ill. App. 2000). In contrast, however, other state courts in similar fact patterns have held to the contrary. For example, the New Jersey Tax Court recently held in *BIS LP, Inc. v. Dir., Div. of Taxation*, 25 N.J.Tax 88 (N.J. Tax 2009), *appeal docketed*, No. A1172-09 (N.J. Super. Ct. App. Div. Nov. 9, 2009), that an out-of-state limited partner with no physical presence in a state cannot be constitutionally taxed by that state under the Commerce Clause, relying on this Court's decisions in *F.W. Woolworth Co. v. Taxation & Revenue Dep't*, 458 U.S. 354 (1982), and

ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307 (1982).

The decision below is one of the most far-reaching departures from the *Quill* physical presence rule to date by a state court, notwithstanding one of the narrowest and purest fact patterns for this Court to consider. If the lower court's decision is left to stand, any out-of-state owner receiving passive investment income from an entity located in a state in which the owner has no physical presence or any physical connection whatsoever, may now be subjected to income taxation jurisdiction by that state. By parity of reasoning, traditional dividend income earned by an out-of-state resident will now be taxable in the distributing state. This is not the law of this Court.

Much has changed in law, society, business, politics and the world during the nearly 20 years since this Court ruled in *Quill* that physical presence in a jurisdiction is a predicate to the constitutional imposition of a state tax. One thing, however, has been and remains constant: the continued disagreement everywhere but at this Court as to the applicability of the principles of *Quill* in state and local taxation. Consequently, this Court should now intervene to resolve these conflicts, foreclose another 20 years of controversy and uncertainty, and re-establish the limits on state taxation under the Commerce Clause as the framers of the Constitution intended.

B. "Modest" Retroactivity – *United States v. Carlton*

A second issue for the Court's consideration involves the retroactive, non-curative tax legislation enacted to the detriment of Petitioners and all other similarly situated taxpayers. In sanctioning this legislation, the lower court ignored the "modesty" requirement of *United States v. Carlton*, 512 U.S. 26 (1994), when analyzing this facially retroactive tax legislation. Justice Blackmun's *Carlton* Opinion, buttressed by the concurring Opinion of Justice O'Connor in *Carlton*, plainly requires a "modesty" analysis. For no other reason than this, the underlying Opinion, simply the latest of many state appellate court decisions to so find, should be reviewed and certiorari granted.

The period of retroactivity *is* a fundamental element to be considered by the judiciary when evaluating retroactive tax legislation; regardless of length, the term must be "modest." The singular point of law arising from *Carlton* traces to the overriding rule that the period of retroactivity must be "modest." As Justice Blackmun wrote for the majority therein, succinctly and plainly, ". . . Second, Congress acted promptly and established only a modest period of retroactivity." *Carlton*, 512 U.S. at 32.

So as to resolve an ever-widening split among the states and bring to a conclusion the plethora of state court litigation and almost continuous retroactive legislating underway, this Court should grant certiorari, hear the dispute, and plainly and unequivocally confirm, 16 years after *Carlton*, that the period of retroactivity in implementing otherwise constitutional, non-curative tax legislation, retroactive on its face, must be "modest."

The concerns of today's citizens as to retrospective tax legislation are the same as those of our founding forefathers in the late 1780s. Today's citizens expect, and in fact are entitled under the Constitution, to be governed by the law of the several states, which, when applied, is sound and fair under the microscope of the Due Process Clause. The national trend on this topic violates these core principles; review by this Court is warranted, necessary and requested.

During the debates leading up to this country's Constitution, the great leaders of our country *specifically addressed* their concern for what they termed "retrospective laws in civil cases." *See* DEBATES IN THE FEDERAL CONVENTION OF 1787 AS REPORTED BY JAMES MADISON, AUG. 28, 1787, H.Doc. No. 398, at 626, 69th Cong. 1st Sess. (1927); *see also* DEBATES IN THE FEDERAL CONVENTION OF 1787 AS REPORTED BY JAMES MADISON, AUG. 29, 1787, H.Doc. No. 398, at 632, 69th Cong. 1st Sess. (1927).[1]

Viewed from our cultural perspective and who we as a people truly are, the scrivener reports of James Madison are most telling — the dilemma faced today, hundreds of years since James Madison recorded such debates, is just as hearty and just as healthy. Now, however, it is time for this Court to once again speak with clarity and authority, and close the debate on this issue.

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1. From a historical perspective, after debate and discussion, the specific reference banning and usurping the power of the states to enact retrospective laws in civil cases was struck, and the ban on legislation impeding contracts took its place. *See generally* U.S. CONST. art. I, § 10.

Retroactive taxation is the very essence of arbitrary action by a legislative body. The arbitrary, and thus punitive, nature of Kentucky's retroactive tax interest statutory changes in question is best demonstrated by briefly reviewing the undisputed facts.

The earliest tax refund at issue was for year 1993 and was filed in 1998; the first Petition of Appeal was filed in 2000 at the Kentucky Board of Tax Appeals ("Board"). After a hearing, the Board ruled in 2006 and ordered a refund payable to Petitioners of approximately $5.1 million, plus interest authorized by law. On first appeal, while reducing the refund award on a substantive issue, the Franklin Circuit Court not only affirmed much of the refund ordered and the interest thereon, but extraordinarily ordered that Kentucky immediately pay the refund. Rather than paying or moving for a Stay of the Order, Respondent appealed.

In conjunction with the Kentucky General Assembly and only weeks after the circuit court Order, Respondent proposed a Bill in 2008, which, on its face, not only changed the interest rate calculus[2] governing the refund within the Judgment in question herein, but also changed the date(s) upon which refund interest commenced to run (*i.e.*, it shortened the number of days of interest *and* reduced the rate of interest). 2008 Ky. Acts. ch. 132 §§ 8, 9, 10, 11, 15.[3]

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2. Moving from a rate driven by the "prime rate" as reported by commercial banks, to a rate of prime rate less 2% on refunds and prime rate plus 2% on assessments.

3. *See also* 2009 Ky. Act. ch. 86 §§ 7, 8, 9, 10 & 15. Pet. App. 87a.

Not to be outdone by the plain text of the changes, the Kentucky General Assembly legislatively pronounced that there: (i) was an "emergency;" (ii) the Bill was effective immediately upon the Governor's signature; and (iii) the text "would govern, control and apply to any claim still pending before . . . the judiciary." Pet. App. 74a-86a. Thus, in one fell swoop, two Orders awarding tax interest to Petitioners were materially reduced, and the law in Kentucky was retroactively rewritten in a manner to statutorily justify same. This arbitrary legislative and executive branch action must stop.

Here, in the face of the facts now before this Court, the question is asked whether a 17 year retroactive change to settled tax law, absent any "curative" need,[4] is *per se* unconstitutional under the Due Process Clause and the *Carlton* "modesty" requirement thereunder.

Hearing the instant case allows the Court to clarify the principles of *Carlton* and its progeny, and provide clarity and much needed bright-lines in a dark and murky area of law. Settled expectations must ripen and mature, for if not now, the question posed becomes — when ever? Certiorari is most appropriate in this case.

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4. The legislative history documents, relied upon by the lower court, confirm this.

STATEMENT OF THE CASE

A. Factual Background

Petitioners' core facts are plain and clear; they have no "physical presence" in Kentucky. All relevant facts applicable to this Petition were stipulated and uncontroverted.

Petitioners maintained no offices, no employees, no places of business and had no real, tangible or intangible property in Kentucky — not even on a transitory basis. All were entities created under the laws of states other than Kentucky (*i.e.*, out-of-state companies); Asworth was a Nevada corporation and HTF and D Aviation were Delaware corporations. All maintained their principal places of business outside of Kentucky.

Petitioners' sole "connection" with Kentucky was that they were partners in two Tennessee-based partnerships that did business in Kentucky (Conwood Company, LP and Conwood Sales Co., LP (collectively "Conwood Companies")). The Conwood Companies were in the business of manufacturing and selling smokeless tobacco. Petitioners had no management, input or other type of control in or over the Conwood Companies, and simply held their interests in Conwood Companies as passive investment interests — Petitioners were pure holding companies. Respondent, Department of Revenue, Finance & Administration Cabinet (f/k/a Revenue Cabinet) is the administrative agency of the Commonwealth of Kentucky, whose responsibility it is to assess and enforce collection of various taxes, including corporation income taxes.

Petitioners filed original Kentucky corporation income tax returns and paid Kentucky corporation income tax calculated by using the standard three-factor apportionment formula of Ky. Rev. Stat. § 141.120, assimilating their individual property, payroll and sales metrics with those from the Conwood Companies to determine the amount of income properly subject to tax by Kentucky.

Respondent undertook a series of audits of Asworth[5] and issued corporation income tax assessments for tax years ending January 31, 1993 through January 31, 1996, contending that it should have apportioned additional income to Kentucky. Asworth disagreed, paid the tax and timely filed amended 1993-1996 returns pursuant to Ky. Rev. Stat. § 134.580, seeking refunds of corporation income tax overpayments on the basis that they had no nexus with Kentucky pursuant to, *inter alia*, the Commerce Clause and Ky. Rev. Stat. § 141.040. Petitioners later filed amended returns for tax years 1997 through 1999 on the same grounds. Respondent denied Petitioners' refund claims and the dispute moved on.

B. Proceedings Below

Petitioners appealed Respondent's denials of their refund claims to the Board. Petitioners contended that they had no physical presence in Kentucky and therefore

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5. HTF and D Aviation were not audited by Respondent nor issued tax assessments.

did not have tax nexus with the state pursuant to, *inter alia*, the Commerce Clause and Kentucky statutory law.[6]

After a hearing on the merits, the Board agreed with Petitioners, finding no tax nexus with Kentucky under Ky. Rev. Stat. § 141.040 because Petitioners did not have any property or employees, and therefore did not have the required physical presence in Kentucky. By ruling on state grounds only, the Board did not reach Petitioners' constitutional assertions. By a January 2006 Order, the Board awarded refunds of all tax overpayments totaling $5.1 million, plus mandatory refund interest pursuant to Ky. Rev. Stat. § 131.183. Pet. App. 47a-50a.

On February 24, 2006, Respondent appealed the Board's Order to the Franklin Circuit Court. In December 2007, the court issued a split decision, holding that Petitioners had tax nexus under Kentucky's statutory scheme, the Commerce Clause and the Due Process Clause, but holding that the proper method of calculation of tax required the use of the three-factor apportionment and assimilation method (based on property, payroll and sales) to determine the amount of tax due to Kentucky. Pet. App. 42a-43a. The Franklin Circuit Court held that Petitioners had nexus, applying *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437

6. Petitioners also contended that they were not subject to tax under the Due Process Clause, and contended, in the alternative, that if they were subject to corporate income taxation by Kentucky, traditional three-factor apportionment methodology and assimilation of their apportionment factors with those of the Conwood Companies was constitutionally and statutorily required to determine the proper amount of income by Kentucky. These questions are not being put before this Court.

S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993) and *Borden Chemicals and Plastics, LP v. Zehnder*, 726 N.E.2d 73 (Ill. App. 2000). Pet. App. 42a. Because a refund still resulted, the circuit court took the extraordinary step of awarding immediate refunds of tax overpayments, plus refund interest pursuant to the version of Ky. Rev. Stat. § 131.183 in effect at the time. Pet. App. 44a.

On December 17, 2007, Respondent appealed the Order to the Kentucky Court of Appeals regarding the circuit court's findings on apportionment, and did not pay the ordered refund. Petitioners filed a cross-appeal regarding the court's findings on nexus and contended that the Commerce Clause and Due Process Clause prohibited Kentucky's imposition of corporate income tax under the facts before the Court because they did not have physical presence or sufficient minimum contacts in Kentucky. Petitioners subsequently filed an unopposed Motion for Leave to Correct Mathematical Error in Circuit Court's Order and to Allow Parties to Brief Issues Concerning House Bill 704 ("Motion").[7]

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7. House Bill 704 was enacted in 2008 and retroactively amended Ky. Rev. Stat. § 131.183 [the statute relied upon by the Board and the circuit court to award interest to Petitioners], Ky. Rev. Stat. §§ 134.580 and 141.235 to change Kentucky's tax refund scheme to reduce the rate of interest paid on refunds from "prime rate" to "prime less 2%," and the calculation start date, so that interest on any tax refund would no longer be calculated beginning 60 days from the latter of the due date of the return or payment of the tax, but would begin to accrue on the date of the filing of an amended return requesting refunds. As a result, in all cases in which amended returns are filed after the due date of the original return and after the date of payment of the tax [which is nearly always], the amount of interest paid by Respondent on all refund claims, including those at issue here, are decreased. *See* 2008 Ky. Acts. ch. 132 §§ 8, 9, 10, 11 & 15.

Petitioners advised the court regarding another enactment, 2009 House Bill 216, which also retroactively amended the law, similarly to House Bill 704, which directly impacted and reduced the (refund) Judgment of Petitioners. *See* 2009 Ky. Acts. ch. 86 §§ 7, 8, 9, 10 & 15. By Order dated April 24, 2009, the court granted Petitioners' Motion and ordered briefing by the parties regarding all issues concerning House Bills 704 and 216 (collectively, "Bills").

The court ultimately rendered its November 2009 decision, affirming the circuit court's determination that Kentucky had statutory authority to tax Petitioners under Kentucky law and had constitutional authority to tax Petitioners under the Commerce Clause. Notwithstanding an assertion that *Quill's* physical presence rule as applied to income tax cases was "unclear," the court held that physical presence existed for Commerce Clause purposes based on Petitioners' receipt of income from the investment interests held in the Tennessee partnerships doing business in Kentucky. Pet. App. 11a.

The court also took judicial notice of the Bills, rejected Petitioners' contentions that *Carlton's* "modesty" requirement was violated by the severe retroactive nature of the Bills, and held that the Bills did not violate, *inter alia*, the Due Process Clause. As to the retroactive period, the court specifically held that *Carlton* "did not establish . . . a 'modesty requirement;' rather, the majority simply noted with favor that 'Congress acted promptly and established only a modest period of retroactivity.'" Pet. App. 20a.

On December 18, 2009, Petitioners timely filed a Motion for Discretionary Review with the Supreme Court of Kentucky, seeking review of the Court of Appeals' holdings. Petitioners' motion was denied on August 18, 2010.

REASONS FOR GRANTING THE PETITION

I. WITHOUT FURTHER REVIEW, THE KENTUCKY DECISION, WHICH ADDRESSES AN IMPORTANT FEDERAL QUESTION OF COMMERCE CLAUSE NEXUS, WILL STAND IN CONFLICT WITH DECISIONS OF OTHER STATE COURTS

Notwithstanding the Parties' Stipulations that Petitioners had no property or employees in Kentucky, the lower court in this case held through its minimalistic and erroneous analysis of the Commerce Clause that Petitioners had "physical presence" in Kentucky sufficient to subject them to corporate income tax based on Kentucky's protection and benefits provided to two Tennessee-based partnerships and Petitioners' passive investments in those partnerships. Pet. App. 11a.

The lower court's decision is at odds with several cases from sister states and represents the latest of a widening split of authorities. Attached for the Court's review is a map illustrating the split among Kentucky's sister states, representing 9 states following *Quill's* physical presence requirement in non-sales tax cases and 14 states rejecting *Quill* in non sales tax cases.[8] Pet.

8. Also attached is a Table of Authorities referenced in the map. Pet. App. 121a.

App. 120a. Further, at least 35 states have enacted legislation, regulations or policies specifically rejecting the physical presence test in income tax settings and stating that holding partnership interests alone creates tax nexus, again contrary to this Court's holding in *Quill*.[9]

The lower court below erroneously relied upon *Borden Chemicals and Plastics, LP v. Zehnder*, 726 N.E.2d 73 (Ill. App. 2000) (holding that limited partner had physical presence in Illinois for Commerce Clause purposes). However, the Illinois court's decision stands in stark contrast to the New Jersey Tax Court's decision in *BIS LP, Inc. v. Dir., Div. of Taxation*, 25 N.J. Tax 88 (N.J. Tax 2009), *appeal docketed*, No. A1172-09 (N.J. Super. Ct. App. Div. Nov. 9, 2009). In *BIS*, the court held that BIS, as a passive investor in a partnership with New Jersey operations, was not subject to New Jersey corporation business tax. *Id.* (citing *F.W. Woolworth Co.* and *ASARCO, Inc., supra*).[10]

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9. *See* 2010 SURVEY OF STATE TAX DEPARTMENTS, pp. 20-22; 42-43 (BNA State Tax ed., BNA) (2010); *See*, e.g., Ky. Rev. Stat. § 141.040 (effective 2005); Conn. Gen. Stat. § 12-214(a)(3); Iowa Code § 422.33(1); S.C. Code Ann. 12-6-530; Wis. Stat. § 71.23(2).

10. The lower court's decision in this case is also contrary to the Alabama state court's decision in *Lanzi v. Alabama Dep't of Revenue*, 968 So.2d 18 (Ala. App. 2006) (nonresident limited partner was not subject to Alabama income taxes under the Due Process Clause; Commerce Clause argument not reached by the court) and the Supreme Court of Missouri's decision in *Acme Royalty Co. v. Dir. of Revenue*, 96 S.W.3d 72 (Mo. 2002). Further, many lower courts and administrative tribunals have also considered, and are continuing to consider, this issue. *See Cerro Copper Prod., Inc. v. Alabama Dep't of Revenue*, No. F. 94-444, 1995 WL 800114 (Ala. Dep't of Revenue, Admin. Law Div.

(Cont'd)

The lower court's decision is also squarely at odds with the Texas Court of Appeals' decision in *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. App. 2000). *Rylander* upheld *Quill's* physical presence rule and held that Texas could not impose the state's franchise tax, a tax on the privilege of doing business in the state, on an out-of-state corporation that did not have a physical presence; *i.e.*, meaning property or employees, in Texas. *See also Midland Cent. Appraisal Dist. v. BP America Prod. Co.*, 282 S.W.3d 215, 224 (Tex. App. 2009); *Peoples Gas, Light, and Coke Co. v. Harrison Cent. Appraisal Dist.*, 270 S.W.3d 208 (Tex. App. 2008). *But see INOVA Diagnostics, Inc. v. Strayhorn*, 166 S.W.3d 394, 402 (Tex. App. 2005), *cert. denied*, 547 U.S. 1072 (2006).

The lower court's decision is also contrary to the Tennessee Court of Appeals' published holding in *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. App. 1999), *cert. denied*, 531 U.S. 927 (2000). The court in *J.C. Penney* held that Tennessee could not constitutionally tax the corporate earnings of non-resident corporations that had no physical presence, again, referring to real or tangible property or employees, in Tennessee. The court explained that no valid distinction could be made for Commerce Clause purposes between income-based taxes and sales and use taxes.[11]

(Cont'd)

Dec. 11, 1995; *see also In the Matter of the Petition of Wascana Energy Mktg. (U.S.), Inc.*, DTA No. 817866, 2002 WL 1726832 (N.Y. Div. of Tax App. Aug. 8, 2002) (Advisory Opinion).

11. *But see America Online, Inc. v. Johnson*, No. M2001-00927-COA-R3-CV, 2002 WL 1751434 (Tenn. App. Jul. 30, 2002) (not officially published and not citable in Tennessee).

The lower court's decision is also in conflict with the Michigan Court of Appeals' decisions in *Guardian Indus. Corp. v. Dep't of Treasury*, 499 N.W.2d 349 (Mich. App. 1993) and *Gillette Co. v. Dep't of Treasury*, 497 N.W.2d 595 (Mich. App. 1993), *cert. denied*, 513 U.S. 1103 (1995). Those decisions applied *Quill's* physical presence rule, requiring the existence of real or tangible property or employees, before imposition of Michigan's "single business tax."

Expressly contrary to *Quill* and the state court decisions applying its physical presence rule, some state appellate courts have held that physical presence is limited to sales and use taxes, and that the Commerce Clause authorizes taxation of non-resident out-of-state companies having no physical presence in a state. This traces to *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13, 18 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993), where the court held that the physical presence rule set forth in *Quill* "had not been extended to other types of taxes," and held that "by licensing intangibles for use in [South Carolina]" by its affiliates, the Delaware corporation had a "substantial nexus" with South Carolina. *Id.* at 18 & n.4.

Several other state appellate courts followed South Carolina's lead, including *Couchot v. State Lottery Comm'n*, 659 N.E.2d 1225, 1230 (Ohio 1996), *cert. denied*, 519 U.S. 810 (1996) ("[t]here is no indication in *Quill* that the Supreme Court will extend the physical-presence requirement to cases involving taxation measured by income derived from the state."); *Buehner Block Co. v. Wyoming Dep't of Revenue*, 139 P.3d 1150, 1158 n.6 (Wyo. 2006) ("*Bellas Hess* and *Quill* have

created the specialized jurisprudence . . . applicable to 'sales or use tax case[s]'"). *See also Kmart Properties, Inc. v. Taxation & Revenue Dep't of the State of New Mexico*, 131 P.3d 27, 35 (N.M. App. 2001), *writ quashed*, 131 P.3d 22, 35-36 (N.M. 2005); *Comptroller of the Treasury v. SYL, Inc.*, 825 A.2d 399, 415-416 (Md. 2003), *cert. denied*, 540 U.S. 984 (2003).

The ever growing judicial split is well known and acknowledged by state courts. *See Bridges v. Geoffrey, Inc.*, 984 So.2d 115, 127 (La. App. 2008), *writ denied*, 978 So.2d 370 (2008) (rejecting *Quill's* physical presence requirement and describing *J.C. Penney* and *Rylander* as not "persuasive"); *Geoffrey, Inc. v. Oklahoma Tax Comm'n*, 132 P.3d 632 (Okla. App. 2005), *cert. denied* (2006) (rejecting *Quill's* physical presence requirement and attempting to distinguish *J.C. Penney* and *Rylander*); *A & F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 196 n.9 (N.C. App. 2004), *cert. denied*, 546 U.S. 821 (2005) (rejecting *Quill's* physical presence requirement and attempting to distinguish *J.C. Penney*); *Gen. Motors Corp. v. City of Seattle*, 25 P.3d 1022, 1028 (Wash. App. 2001), *cert. denied*, 535 U.S. 1056 (2002) (rejecting physical presence standard and noting that the taxpayers "correctly argue that some state courts have extended the physical presence rule.").

The New Jersey and West Virginia Supreme Courts have specifically faced the split of states regarding the application of *Quill*. *See Lanco, Inc. v. Dir., Div. of Taxation*, 908 A.2d 176, 177 (N.J. 2006), *cert. denied*, 551 U.S. 1131 (2007) ("[s]ince the Court decided *Quill*, a split of authority has developed regarding whether the Supreme Court's holding was limited to sales and

use taxes."). *See Tax Com'r of State v. MBNA America Bank, N.A.*, 640 S.E.2d 226, 231 (W.Va. 2006), *cert. denied*, 551 U.S. 1141 (2007) (stating that the issue of whether *Quill* applies to income and franchise taxes was a "major question left open by the Supreme Court's opinion."[12]; *see also Capital One Bank v. Com'r of Revenue*, 899 N.E.2d 76 (Mass. 2009), *cert. denied*, 129 S.Ct. 2827 (U.S. 2009); *Geoffrey, Inc. v. Com'r of Revenue*, 899 N.E.2d 87 (Mass. 2009), *cert. denied*, 129 S.Ct. 2853 (U.S. 2009).

The lower court endorsed a broad assertion of extraterritorial taxation power, disregarded well-reasoned court decisions and concluded that Kentucky could tax an investor receiving investment income from a separate and distinct entity operating in Kentucky for the sole reason that the in-state entity was receiving Kentucky's "protection and benefits." The lower court's decision thus brings the post-*Quill* chaotic state of affairs full circle, beginning with South Carolina's *Geoffrey* decision holding that physical presence was not needed for taxation for out-of-state companies in the context of intangible holding companies, through the lower court's holding that a state may tax an out-of-state company even where there is no intangible property in the state but merely receives distributive income from a business receiving "protection and benefits" from Kentucky.

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12. *See also Chase Manhattan Bank v. Gavin*, 733 A.2d 782 (Conn. 1999), *cert. denied*, 528 U.S. 965 (1999) (noting that *Quill* was not limited to sales and use tax related disputes, although it ultimately concluded that there was no Commerce Clause violation).

This pervasive ongoing split of authority among the lower courts constitutes substantial reason for this Court to grant review of this important case, and certiorari is warranted.

II. WITHOUT FURTHER REVIEW, THE KENTUCKY DECISION WILL EFFECTIVELY OBLITERATE THE PHYSICAL PRESENCE TEST SET FORTH IN *QUILL* AND SUBSTITUTE A "METAPHYSICAL" PRESENCE TEST

"The very purpose of the Commerce Clause [is] to ensure a national economy free from . . . unjustifiable local entanglements." *Nat'l Bellas Hess v. Dep't of Revenue of Illinois*, 386 U.S. 753, 760 (1967). This Court's decision noted the distinction between constitutional taxation of companies with property or employees in a state and unconstitutional taxation of companies with no property or employees in a state. *Id.* at 758. "[T]his basic distinction," this Court observed, "until now has been generally recognized by the state taxing authorities," and "is a valid one." *Id.* This Court therefore held that it "decline[d] to obliterate it." *Id.*

Later, this Court reaffirmed the physical presence standard and set forth a four-part test for proper state taxation under the Commerce Clause in *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977). *Complete Auto* held that to satisfy the constitutional prerequisites, a tax: (1) must be "applied to an activity with a *substantial nexus* with the taxing state;" (2) must be "fairly apportioned;" (3) must "not discriminate against interstate commerce;" and (4) must be "fairly related to the services provided by the state." *Id.* at 279 (emphasis

added). *See also Barclays Bank PLC v. Franchise Tax Bd. of California*, 512 U.S. 298, 310-311 (1994) (reaffirming *Complete Auto* standard).

In *Quill*, this Court plainly reaffirmed and highlighted the viability of the physical presence rule and noted that its holding was not limited to sales and use taxes. This Court observed:

> we have never intimated a desire to reject an established "bright-line" test. Although we have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes, that silence does *not* imply repudiation of the *Bellas Hess* rule.

Quill, 504 U.S. at 314 (emphasis added). This Court went on to hold that ". . . the bright-line rule of *Bellas Hess* furthers the ends of the dormant Commerce Clause." *Id.* Accordingly, this Court specifically held that "substantial nexus" between a taxing State and an out-of-state corporation is met only where the corporation has a "physical presence" in the taxing state. *Id.*

Moreover, this Court recognized in *Quill* that the bright-line rule articulated in *National Bellas Hess* "furthers the ends of the dormant Commerce Clause" and it "encourages settled expectations and, in doing so, fosters investment by businesses and individuals." *Id.* at 314-16. It is critical to note that this Court, as explained in *Quill*, has *never* found "substantial nexus" in the absence of physical presence in matters brought before it. Further, this Court has never suggested that

the meaning of "substantial nexus" varies depending on the type of tax involved. As Professor Pomp opined below in the Board hearing in this matter: "The Constitution does not distinguish between sales and use taxes and income taxes: there is only one nexus standard and the U.S. Supreme Court has endorsed physical presence." Pet. App. 114a. There is only one Constitution after all.

Such a shifting test, one requiring physical presence in sales and use tax cases while allowing "metaphysical presence" in income tax cases, would create unconscionable results. Indeed, this Court has applied "substantial nexus" principles arising from sales and use tax cases to disputes involving other types of state taxes. *See Tyler Pipe Indus., Inc. v. Washington State Dep't of Revenue*, 483 U.S. 232 (1987), *cert. denied*, 486 U.S. 1040 (1988). *Tyler Pipe* relied on *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960), involving use tax issues, to determine if a taxpayer had substantial nexus with a state that subjected it to a business tax.

As this Court specifically held in *Quill*, 504 U.S. 298, 315 at n.8, a "slightest presence" or "minimal nexus" is *not* sufficient to establish nexus under the Commerce Clause. Indeed, as Justice White pointed out in *Quill*, "reasonable minds surely can, and will, differ over what showing is required to make out a 'physical presence' adequate to justify imposing responsibilities for use tax collection." *Quill*, 504 U.S. at 330, 331 (concurring in part and dissenting in part). Petitioners' passive investment holdings in Tennessee entities having Kentucky operations simply cannot as a matter of law rise to the level of "substantial nexus" under this Court's previous decisions and standing precedent.

In contrast, the lower court erred and juxtaposed Commerce Clause "substantial nexus" with the "purposeful availment" standard that defines "minimum contacts" under Due Process. *See Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 775 (1985). Contrary to the lower court's decision, whether Petitioners receive "protection and benefits" from Kentucky is not the correct question to ask in a Commerce Clause analysis.

As this Court explained in *Quill*, the Commerce Clause and the Due Process Clause reflect very different concerns and thus use very different analyses:

> Due Process centrally concerns the fundamental fairness of governmental activity. Thus, at the most general level, the due process nexus analysis requires that we ask whether an individual's connections with a state are substantial enough to legitimate the state's exercise of power over him. We have, therefore, often identified "notice" or "fair warning" as the analytic touchstone of due process nexus analysis. In contrast, the Commerce Clause and its nexus requirement are informed not so much by concerns about fairness for the individual defendant as by structural concerns about the effects of state regulation on the national economy.

Quill, 298 U.S. at 312.

This Court has held that "... a corporation may have the 'minimum contacts' with a taxing State as required by the Due Process Clause, and yet lack the 'substantial nexus' with that State as required by the Commerce

Clause." *Quill*, 298 U.S. at 313. The lower court's substitution of due process "protection and benefits" for the Commerce Clause's requirement of "physical presence" "substantial nexus" per *Quill* was grave error, one of nation-wide consequence that materially harms and furthers the conflicts presented.

As Professor Pomp opined in this case:

> [B]y any principled measure of comparison, physical presence is to be preferred to metaphysical presence as a nexus standard. Physical presence is more consistent with a bright line test, more consistent with settled expectations, more likely to reduce litigation and foster interstate investment, less likely to discriminate against the service sector, less likely to lead to multiple taxation, more easily administered, and more compatible with the growth of electronic commerce.
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> * * *
>
> [M]etaphysical presence is less a legal principle and more an invitation to chaos and multiple taxation, thus undercutting the very goals of the commerce clause that the concept of nexus is intended to further.

Pet. App. 114a.

Petitioners have absolutely *no* physical presence in Kentucky, as stipulated to by Respondent — no real, tangible or intangible property, no office and no employees located in Kentucky. Boiled down, the lower court's decision held that Petitioners have "metaphysical

presence," as coined by Professor Pomp, and therefore "minimal nexus" in Kentucky — merely because Kentucky provided "protection and benefits" to two Tennessee-based entities in which Petitioners held passive investments from which they received income.

Under the lower court's reasoning, *all* companies will now be subject to state taxation so long as they receive income from an in-state company receiving "protection and benefits" from that state, presumably resulting in the taxation of, *inter alia*, passive dividend income of non-residents. As Professor Pomp opined below:

> An out-of-state corporate partner that is a passive investor in a partnership should be treated the same as an out-of-state shareholder in a corporation. Such a partner should be viewed as separate from the partnership just the way a shareholder is viewed as separate from a corporation. The activities of a traditional corporation are not attributed to its shareholders; similarly, the activities of the partnership should generally not be attributed to its partners. Consequently, an out-of-state partner that has no property or payroll of its own in Kentucky should not be viewed as having nexus with Kentucky just because the partnership has property or payroll in the State.

Pet. App. 119a. The lower court's flawed substitution of Due Process Clause analysis for Commerce Clause analysis is material, harmful and should be reviewed by this Court. Certiorari is warranted.

III. WITHOUT FURTHER REVIEW, THE LOWER COURT'S DECISION EVISCERATES THE "MODESTY" REQUIREMENT OF *CARLTON*, AND FURTHERS A SPLIT ON THE CONSTITUTIONAL STANDARDS TO GOVERN RETROACTIVE TAX LEGISLATION

In *United States v. Carlton*, 512 U.S. 26 (1994), with Justice Blackmun writing for a unanimous Court on the merits, this Court was clear that for retrospective amending legislation not to run afoul of the Due Process Clause, the involved Act must ". . . establish[ ] only a modest period of retroactivity." *Id.* at 32. If for no other reason than to bring to a conclusion the plethora of *Carlton*-related litigation, literally from all across the country,[13] this Court should grant certiorari and hear the dispute so as to plainly and unequivocally state that the period of retroactivity when implementing non-curative tax legislation made retroactive on its face must be "modest."

Carlton was hoped to be a solution to the retroactive tax legislation issue. However, far from avoiding or resolving disputes, many state court jurists see this constitutional predicate as *dicta*; others simply ignore it. The modesty requirement set forth in *Carlton* lead Justices Scalia and Thomas to aptly predict:

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13. *See Triple-S Mgmt., Corp. v. Mun. Revenue Collection Ctr.*, 130 S.Ct. 3498 (U.S. 2010) (involving an appeal to the Supreme Court of the Commonwealth of Puerto Rico concerning a period of retroactivity beyond 15 years).

> The reasoning the Court applies to uphold the statute in this case guarantees that *all* retroactive tax laws will henceforth be valid.

Id. at 40 (Scalia & Thomas, JJ., concurring) (emphasis in original).

Hearing the instant case affords the Court an opportunity to clarify *Carlton* and its progeny, and to offer bright-lines to ever growing competing lines of authorities and resolve an ever-widening split across the nation.

A. The Courts Of Kentucky And Other States Are Rejecting The Premise That *Carlton* Requires A "Modest" Period Of Retrospective Application

Over the past 16 years, dozens of cases across the country have addressed what has come to be known as the *Carlton* "modesty analysis." *See, e.g., Miller v. Johnson Controls, Inc.*, 296 S.W.3d 392, 399-400 (Ky. 2009), *cert. denied*, 130 S.Ct. 3324 (U.S. 2010). Some commentators and courts assert that as a matter of law, no "modesty" predicate underlies this Court's *Carlton* Due Process analysis. Quite the contrary, Justice Blackmun's words are clear, concise, and unequivocal — he could not have used fewer words.

Case law, some applying a *Carlton*-like modesty test and some not, is varied and diverse across the nation. The breadth of the split is apparent. In *Estate of Edward Kunze v. Com'r of Internal Revenue*, 233 F.3d 948, 954 (7th Cir. 2000), for example, the court relied on

Carlton's "modesty" requirement in upholding a statute with an eleven-month retroactivity period. *See also, e.g.*, *Kitt v. United States*, 277 F.3d 1330, 1334-35 (Fed. Cir. 2002) (seven-month period); *Quarty v. United States*, 170 F.3d 961, 965-68 (9th Cir. 1999) (eight-month period); *Kane v. United States*, 942 F.Supp. 233, 234 (E.D. Pa. 1996) (eight-month period); *Gardens at W. Maui Vacation Club v. County of Maui*, 978 P.2d 772, 782-83 (Haw. 1999) (six-month period); *cf. Jefferson County Comm'n v. Edwards*, --- So.3d ---, 2010 WL 1946274, at *4, *9 (Ala. May 14, 2010) (citing *Carlton* as requiring a "modest" retroactivity period).

Still further, in *Montana Rail Link v. United States*, 76 F.3d 991 (9th Cir. 1996), the Ninth Circuit held that a shorter period of retroactivity would have been arbitrary, yet it did not specifically address the "modesty" issue. *Id.* at 993-994. *Enter. Leasing Co. of Phoenix v. Arizona Dep't of Revenue*, 211 P.3d 1 (Ariz. App. 2008), advocated leeway for retroactivity beyond one year when a legislature acts promptly. *Enterprise Leasing*, 211 P.3d at 6 (upholding a six-year retroactive period). An Alabama Court has found a two to three-year period "modest" in *Monroe v. Valhalla Cemetery Company, Inc.*, 749 So.2d 470, 474-475 (Ala. App. 1999), *cert. denied*, 529 U.S. 1022 (2000). A New York court has emphasized the need for flexibility when retroactive tax legislation is implemented in response to a federal constitutional infraction, and, in so holding, did not even mention or cite to *Carlton*. *See Moran Towing Corp. v. Urbach*, 1 A.D.3d 722, 724-725, 768 (N.Y.A.D. 2003). And in *Miller*, Kentucky's highest court stressed that what is modest depends on the circumstances and facts of the case, and disregarded the modesty test as an

overriding element. *Miller v. Johnson Controls, Inc.*, *supra*.[14]

Over only the last few months it has been demonstrated, once again, that the split continues. *See Zaber v. City of Dubuque*, --- N.W.2d ---, 2010 WL 2218625 (Iowa 2010) (five-year retroactive new tax was upheld; emphasis on "curative" nature used); *Ford Motor Credit Co. v. Michigan Dep't of Treasury*, No. 289781 (Mich. App. Jan. 12, 2010) (unreported), *petition for cert. filed*, (U.S. Oct. 12, 2010) (No. 10-481). (retroactive legislation abrogating a tax refund sanctioned).

Recognizing the ongoing rift as to the breadth and scope of *Carlton*,[15] in conjunction with the ongoing events in Congress concerning dozens of expiring (or expired) tax changes, this Court and countless others undoubtedly face yet another round of upcoming litigation concerning retroactive legislation without intervention by this Court.

14. Still other courts have opined on *Carlton* and its modesty provisions. *See Rivers v. State*, 490 S.E.2d 261, 277-79 (S.C. 1997) (holding two to three-year period not modest); *City of Modesto v. Nat'l Med. Inc.*, 27 Cal.Rptr.3d 215, 222 (Ca. App. 2005); *Buerer v. United States*, 141 F.Supp.2d 611, 614 (W.D.N.C. 2001) (minimizing the importance of the *Carlton* "modesty" text).

15. Commentators have written extensively on the topic of retroactive tax legislation; the progression is worthy of review. *See* Frederick A. Ballard, *Retroactive Federal Taxation*, 48 Harv. L. Rev. 592 (1935); Charles B. Hochman, The Supreme Court and the Constitutionality of Retroactive Legislation, 73 Harv. L. Rev. 692 (1960); Faith Colson, *The Supreme Court Sounds the Death Knell for Due Process Challenges to Retroactive Tax Legislation*, 27 Rutgers L.J. 243 (1995) and the authorities therein.

The period of retroactivity *is* a fundamental element to be considered by the judiciary when evaluating retroactive tax legislation; regardless of length, it must be "modest." The plain rejection of the *Carlton* modesty requirement by the lower court and the Kentucky Supreme Court in *Miller, supra*, demonstrates the need for this Court's intervention herein — *but for* clarity on this issue by way of granting certiorari herein, the prescient words of Justices Scalia and Thomas will continue to ring true. *See Carlton*, 512 U.S. at 39-42 (Scalia & Thomas, JJ., concurring).

This Court's progression of closely analyzing retrospective tax legislation is long and deep. *See, e.g., Untermyer v. Anderson*, 276 U.S. 440 (1928); *Cooper v. United States*, 280 U.S. 409 (1930); *Milliken v. United States*, 283 U.S. 15 (1931); *United States v. Hudson*, 299 U.S. 498 (1937); *Welch v. Henry*, 305 U.S. 134 (1938); *United States v. Darusmont*, 449 U.S. 292 (1981); *Pension Benefit Guar. Corp. v. R.A. Gray & Co.*, 467 U.S. 717 (1984); *United States v. Hemme*, 476 U.S. 558 (1986). While the facts certainly change from circumstance to circumstance, the scrutiny applied remains true under *Carlton*.

These cases and their holdings notwithstanding, as Justice O'Connor plainly noted in her concurrence in *Carlton*:

> In every case in which we have upheld a retroactive federal tax statute against due process challenge, however, the law applied retroactivity for only a relatively short period prior to enactment.

Carlton, 512 U.S. 26, 38 (O'Connor, J. concurring).

In contrast, the lower Kentucky court herein interpreted *Carlton* in a completely different manner and from a wholly different paradigm:

> The Corporations also contend that the four-year period[16] of retroactivity in this case fails to meet the "modesty requirement" of retroactive tax legislation under *Carlton*. However, contrary to the Corporations' assertion, the holding in *Carlton* did not establish such a "modesty requirement;" rather, the majority simply noted with favor that "Congress acted properly and established only a modest period of retroactivity."

Pet. App. 20a.

Certiorari is respectfully requested so that the Court may review the 17-year retrospective period called into question because of the Bills, and clarify the law so as to fill in the monumental divide across the country on the meaning and import of *Carlton's* "modesty" requirement.

B. When Retrospective Legislation Is "Non-Curative" In Nature, Due Process Should Require More, Not Less, "Modesty" For The Period Involved

Congress has for generations seen fit to enact curative legislation, so-called as it is designed to "fix an

16. This finding is flawed, in that, applied to Petitioners, the facial retrospective period approaches 17 years.

ill" or "cure an evil." The cases suggest that legislation designed to cure drafting errors in the drafting of tax legislation, and to close "loopholes" created in the legislative process, is an appropriate subject for retroactive treatment. *See, e.g., Graham & Foster v. Goodcell*, 282 U.S. 409, 428 (1931) (stating that the power to enact curative statutes is unequivocally valid). This concept, too, seemingly applies to legislation designed to thwart circumstances of tax evasion. In *Untermyer, supra*, Justice Brandeis highlighted that the retroactive features of the challenged statute had "a special justification" because they were designed to prevent evasion of the tax. *Id.* at 450.

Alas, the *Carlton* case involved just such a curative legislative situation — an effort by Congress to correct what it asserted were unintentionally enacted "loopholes." In its starkest terms, a circumstance where Congress originally projected a tax break of $300 million, was in hindsight of mere months revised and projected at $7 billion — clearly a legislative effort to address the oft-referred to "law of unintended consequences." Designed to retroactively remedy what it saw and publicly asserted was a "patent abuse," Congress' Act at question in *Carlton* does in fact represent a rational method accompanying a legitimate governmental purpose when seen as the curative legislation it was.[17]

17. As to the "curative" nature thereof, *see* Briefs of Petitioner, United States of America, *United States v. Carlton*, 512 U.S. 26 (1994), reprinted at 1993 WL 638225 (U.S.), Reply Brief of Petitioner, United States of America, *United States v. Carlton*, 512 U.S. 26 (1994), reprinted at 1993 WL 13010930 (U.S.), making it clear that the Petitioner, United States, saw the case as only involving a curative-tax amendment designed to plug a loophole.

To state the obvious, retroactivity is disfavored under fundamental notions of justice. *Eastern Enterprises v. Apfel*, 524 U.S. 498, 532 (1998).[18] Accordingly, this Court has observed that "statutory retroactivity has long been disfavored" [*Landgray v. U.S.I. Film Prods.*, 511 U.S. 244, 268 (1994)], curative amendments being an exception. The Bills in question herein were not "curative," there was no fiscal crisis and accordingly there is no appropriate justification to override the modesty predicate of *Carlton*.

Retrospective amendments are in some instances a violation of the fundamental fairness citizens demand; no less than the credibility of our government is at stake. Trust in government is fundamental and axiomatic in a country of laws, not men. *See St. Regis Paper Co. v. United States*, 368 U.S. 208, 209 (1961) (Black, J., dissenting) ("It is no less good morals and good law that the Government should turn square corners in dealing with their Government."); *Federal Crop Ins. Corp. v. Merrill*, 332 U.S. 380, 387-88 (1947) (Jackson, J., dissenting) ("It is very well to say that those who deal with the Government should turn square corners. But there is no reason why the square corners should constitute a one-way street").

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18. *See also Harper v. Virginia Dep't of Taxation*, 509 U.S. 86 (1993) (Scalia, J., concurring) (noting that "original and enduring American perception of the judicial role sprang . . . from the jurisprudence of Blackstone, which viewed retroactivity as an inherent characteristic of the judicial power, a power 'not delegated to pronounce a new law, but to maintain and expound the old one.'") (quoting 1 W. Blackstone, *Commentaries* *69 (1765)).

The concerns today as to retrospective tax legislation are the same as that of our forefathers over 200 years ago when debating the Constitution. Clarity is needed. While we know that a 30 to 50-year period of retroactivity "is far from outside the bounds of retroactivity permissible" under due process analysis [*Eastern Enterprises v. Apfel*, 524 U.S. 498, 550 (1998)], the question remains, what period of retroactivity is not "modest?" Only certiorari will appropriately address this issue.

CONCLUSION

For the foregoing reasons, the Petition for Writ of Certiorari should be granted.

Respectfully submitted,

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APPENDIX

APPENDIX A — OPINION AFFIRMING IN PART, REVERSING IN PART, AND REMANDING, COMMONWEALTH OF KENTUCKY COURT OF APPEALS DATED NOVEMBER 20, 2009

COMMONWEALTH OF KENTUCKY
COURT OF APPEALS

NO. 2007-CA-002549-MR
AND
NO. 2008-CA-000023-MR

APPEAL AND CROSS-APPEAL FROM
FRANKLIN CIRCUIT COURT
HONORABLE THOMAS D. WINGATE, JUDGE
ACTION NO. 06-CI-00288

REVENUE CABINET (N/K/A FINANCE AND ADMINISTRATION CABINET, DEPARTMENT OF REVENUE), COMMONWEALTH OF KENTUCKY

APPELLANT/CROSS-APPELLEE

V.

ASHWORTH CORPORATION (N/K/A ASHWORTH, LLC), HT-FORUM, INC. (N/K/A HTF, LLC); AND D AVIATION SERVICES, INC. (N/K/A D AVIATION SERVICES, LLC

APPELLEES/CROSS-APPELLANTS

OPINION
AFFIRMING IN PART, REVERSING IN PART, AND REMANDING

* * * * * * * * * *

Appendix A

BEFORE: CLAYTON, NICKELL, AND VANMETER, JUDGES.

VANMETER, JUDGE: The Revenue Cabinet, Commonwealth of Kentucky (n/k/a Finance and Administration Cabinet, Department of Revenue) (the Cabinet) appeals from the Franklin Circuit Court's order reversing the order of the Kentucky Board of Tax Appeals (Board). Asworth Corporation (n/k/a Asworth, LLC), D Aviation Services, Inc. (n/k/a D Aviation Services, LLC), and HT-Forum, Inc. (n/k/a HTF, LLC), (collectively the Corporations) cross-appeal from the same order. For the following reasons, we affirm the circuit court's order to the extent that it held that the Corporations have a tax nexus with Kentucky. We reverse insofar as it applied the three-factor apportionment method and ordered an immediate refund.

While this matter was pending before the Board, the parties stipulated to, *inter alia*, the following facts.[1] The Corporations were created under the laws of either Nevada or Delaware, all with their principal places of business in Chicago, Illinois. The Corporations "manage investments in various legal entities." None of the Corporations had any property, employees, or payroll in Kentucky during the tax years at issue. Nor have the Corporations ever been domiciled in Kentucky. Their sole connection with Kentucky was their "receipt of a distributive share of partnership income received from

1. We quote at times from the parties' stipulations.

the profits of variously named and organized partnerships doing business in Kentucky." Board Order at 2.

1993-1996

For the taxable periods ending on January 31 of 1993, 1994, 1995, and 1996, "Asworth filed Kentucky corporation income tax returns . . . and paid Kentucky corporate income tax calculated by using the standard three-factor apportionment formula (property, payroll, and receipts) under KRS[2] 141.120 to apportion its multistate income to Kentucky, and included the property, payroll and receipts of" both Asworth and Conwood Company, LP, a Delaware limited partnership of which Asworth owned a 99% limited partnership interest. Conwood is a Delaware limited partnership which has its principal place of business in Tennessee, and which also conducts business in Kentucky. "Asworth also filed Kentucky corporation license tax returns and paid the Kentucky corporate license tax of KRS 136.070 using the same methodology it utilized for corporate income tax for" these tax years.

Based on its audit of Asworth for these tax years, the Cabinet concluded that although Asworth was not required to file a corporation license tax return, it owed additional taxes, plus applicable interest and penalties. The Cabinet excluded Asworth's receipts and all of its affiliated entities in assessing the additional taxes,

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2. Kentucky Revised Statutes.

including "only Conwood receipts in Kentucky [presented in the formula] over Conwood receipts everywhere in the calculation(s)." That is, the Cabinet utilized a single-factor apportionment formula.

Asworth paid the taxes as assessed by the Cabinet, and then filed amended returns requesting a refund for the taxes it paid in relation to its original returns, as well as the increased amount it paid in relation to the Cabinet's audit assessment, plus the applicable interest and penalties. Asworth argued "that it had no nexus with Kentucky under KRS Chapter 141, and therefore was not subject to corporate income tax." The Cabinet denied Asworth's request for a refund, and Asworth appealed to the Board.

1997-1999

For the taxable periods ending January 31, 1997, and December 31 of 1997, 1998, and 1999, the Corporations each filed Kentucky corporation income tax returns and paid Kentucky corporation income tax. Through various corporate structure changes and transfers not pertinent here, at some point D Aviation Services and HT-Forum acquired ownership interests in Conwood.

Thereafter, the Corporations filed amended returns requesting refunds for the sums they paid for these taxable periods, plus interest. The Corporations argued that they did not have any tax liability in Kentucky. The

Cabinet denied the requests for refunds,[3] and the matters were eventually appealed to the Board.

Procedural Posture

On appeal to the Board, the Corporations' appeals were consolidated pursuant to a motion which indicated that the appeals concerned the same issues, related to the same tax, and involved related entities. Ultimately, the Board held that "KRS 141.040 did not reach the distributive share paid to [the Corporations] by partnerships doing business in the Commonwealth" since they did not own property, lease property, or have any employees receiving compensation in Kentucky. Thus, the Corporations did not have a "physical presence" in Kentucky and were not subject to Kentucky corporation income tax.

On appeal, the circuit court reversed, holding that the Corporations were "subject to tax on their distributive share income from partnerships doing business both within and without Kentucky pursuant to KRS 141.206." The circuit court calculated the amount owed based upon the ratio of sales, property, and payroll in Kentucky to total sales, property, and payroll everywhere in the United States (the three-factor method). This appeal and cross-appeal followed.

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3. While the Cabinet never ruled on Asworth's claim regarding any refund for the taxable period ending January 31, 1997, the parties agree that the outcome here will also apply to that claim.

Following oral argument on the merits of the case, the Corporations moved for leave to correct a mathematical error in the circuit court's order and to allow the parties to brief issues concerning 2008 Regular Session House Bill (H.B.) 704 or to remand the case to the circuit court for review of H.B. 704. The Cabinet, in response, stated that it did not oppose the motion. Thereafter, this court granted the Corporations' motion, ordering a mathematical revision of the circuit court's order entered December 4, 2007, taking judicial notice of the enactment of 2008 Ky. Acts, c. 132 § 8 (*repealed and reenacted* by H.B. 216, 2009 Gen. Assem., Reg. Sess. (Ky. 2009) (enacted)), (collectively the Bills), and granting leave for the parties to brief issues concerning the Bills. These issues will be addressed following our discussion of the circuit court's order reversing the order of the Board.

Whether Statutes Require Taxation

First, the Corporations argue on cross-appeal that the circuit court erred by finding that the Corporations are subject to taxation pursuant to KRS 141.206(5). We disagree.

KRS 141.040(1) provides[4] that with certain exceptions, the following shall pay for each taxable year a tax on taxable net income: "every foreign corporation owning or leasing property located in this state or

4. Unless otherwise noted, we quote from the statutes as in effect July 15, 1996.

having one (1) or more individuals receiving compensation as defined in KRS 141.120(8)(b) in this state[.]" The Corporations argue that since the parties stipulated that the Corporations did not own property, lease property, or have individuals receiving compensation in Kentucky, they are not subject to Kentucky corporate income tax. The Cabinet argues that the circuit court correctly held that regardless of KRS 141.040(1), the Corporations are subject to taxation pursuant to KRS 141.206(5), which provides:

> Nonresident individuals and corporations which are partners in a partnership or shareholders in an S corporation which does business within and without Kentucky are taxable on their proportionate share of the distribute income passed through the partnership or S corporation attributable to business done in Kentucky.

Simply put, we agree with the Cabinet and the circuit court that the plain language of KRS 141.206(5) subjects the Corporations to taxation. A different result is not compelled, as the Corporations suggest, by the fact that KRS 141.206(5) does not contain the words "shall pay." We hold that the words "are taxable" are sufficient to impose tax liability in this situation. Further, a different result is not compelled by any subsequent amendments to these statutes.

Appendix A

Void for Vagueness

The Corporations assert that KRS 141.206 is void for vagueness. In *Bd. of Trs. of the Judicial Form Ret. Sys. v. Attorney Gen.*, 132 S.W.3d 770 (Ky. 2003), the Kentucky Supreme Court held that unintelligible legislation was a nullity. Specifically, the court stated:

> The void-for-vagueness doctrine is most often applied in the context of the First Amendment, the criminal law, and punitive civil laws. *See, e.g. Martin v. Commonwealth, Ky.*, 96 S.W.3d 38, 59-60 (2003) (First Amendment); *Jones v. Commonwealth, Ky.*, 830 S.W.2d 877, 880 (1992) (criminal law); *Vill. of Hoffman Estates v. Flipside*, 455 U.S. 489, 499-500, 102 S.Ct. 1186, 1193-94, 71 L.Ed.2d 362 (1982) (civil penalties). However, while statutes affecting those areas should receive the most *rigorous* review and are most *commonly* held void for vagueness, non-punitive civil, regulatory, or spending statutes are also invalid if they are so unintelligible as to be incapable of judicial interpretation. In that circumstance, the statute often is declared void for "unintelligibility" or "uncertainty" as opposed to "vagueness."
>
> The most oft-cited expression of this doctrine in Kentucky is *Folks v. Barren County*, 313 Ky. 515, 232 S.W.2d 1010 (1950), in which our predecessor court was asked to

> interpret a statute allowing boards of education to finance new school buildings through direct appeals to voters. The Court noted the following proposition of law:
>
> > It is not for us to say the Legislature does not have the right to be indirect where it could be direct, or to be obscure and confusing where it could be clear and simple. But where the law-making body, in framing the law, has not expressed its intent intelligibly, or *in language that the people upon whom it is designed to operate or whom it affects can understand, or from which the courts can deduce the legislative will,* the statute will be declared to be inoperative and void.

Id. at 778. We hold that this principle has no applicability to the instant statute.

The legislative will expressed in KRS 141.206(5) is intelligible. It expresses the policy that nonresident corporations, such as the Corporations herein, which are partners in a partnership doing business within and without Kentucky are taxable on their proportionate share of distributive income passed through the partnership attributable to business done in Kentucky. The Corporations' allegations of deficiencies—absence of tax rate, "imposition" language, lack of clarity—are without merit. The applicable tax rate is supplied by KRS 141.040. As noted above, the statute contains imposition language. And, the statute is sufficiently

clear. This conclusion is supported in part by the fact that Asworth filed a corporate income tax return in the first place. The statute is not void for vagueness, *i.e.*, unintelligibility.

Commerce Clause

Next, the Corporations argue that subjecting them to tax under KRS 141.206(5) violates the Commerce Clause. We disagree.

To withstand an attack on Commerce Clause grounds, a tax must be: (1) nondiscriminatory toward interstate commerce; (2) applied to one or more activities with a substantial nexus with the taxing state; (3) fairly apportioned; and (4) fairly related to services provided by the state. *Revenue Cabinet v. Ashland Oil, Inc.*, 888 S.W.2d 701, 704 (Ky.App. 1994) (quoting *Complete Auto Transit v. Brady*, 430 U.S. 274, 97 S.Ct. 1076, 51 L.Ed.2d 326 (1977)).

While the Corporations assert in their brief that taxing them under KRS 141.206(5) violates each of the *Complete Auto Transits* prongs, they seriously argue only with regard to the second prong. The Corporations cite *Quill Corp. v. North Dakota*, 504 U.S. 298, 112 S.Ct. 1904, 119 L.Ed.2d 91 (1992), in arguing that the "substantial nexus" requirement can only be satisfied through a physical presence with the taxing state, which is a status the Corporations do not have with Kentucky. In addressing the sales and use taxes at issue in *Quill*, the Supreme Court reaffirmed its previous bright-line

rule that "a vendor whose only contacts with the taxing State are by mail or common carrier lacks the 'substantial nexus' required by the Commerce Clause." 504 U.S. at 311, 112 S.Ct. at 1912. However, the Supreme Court recognized that it had not articulated the same physical-presence requirement in reviewing other types of taxes. 504 U.S. at 314, 112 S.Ct. at 1914. Thus, the applicability of *Quill*'s physical presence requirement to income tax cases, such as the matter before us, is unclear. Nevertheless, even if a substantial nexus requires a physical presence in Kentucky, for the reasons stated hereafter we hold that the Corporations in fact have such a nexus.

Again, while the Corporations do no business in Kentucky, at various times they have owned up to a 99% limited and/or general partnership interest in, and have received distributive shares of partnership income from the profits of, a partnership which does business in Kentucky. Such a partnership unquestionably has received protection and benefits from Kentucky, thereby enabling the distribution of income to the Corporations. We hold that this connection gives rise to a substantial nexus with, and/or a physical presence within, Kentucky. *Accord Borden Chemicals & Plastics, L.P. v. Zehnder*, 312 Ill. App. 3d 35, 726 N.E.2d 73, 79-82, 244 Ill. Dec. 477 (Ill.App. 2000) (commerce clause does not prohibit Illinois from assessing replacement tax on a limited partner which has no connection with the State of Illinois other than investing in a partnership). The cases from other jurisdictions cited by the Corporations and/or the tax expert's testimony below regarding the physical presence standard do not compel a different result.

Appendix A

Due Process Clause

Next, the Corporations argue that subjecting them to tax under KRS 141.206(5) violates the Due Process Clause of the Fourteenth Amendment. We disagree.

The *Quill* court explained that "[t]he Due Process Clause 'requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax[.]'" 504 U.S. at 306, 112 S.Ct. at 1909 (quoting *Miller Brothers Co. v. Maryland*, 347 U.S. 340, 344-45, 74 S.Ct. 535, 539, 98 L.Ed. 744 (1954)). The Court has "framed the relevant inquiry as whether a defendant had minimum contacts with the jurisdiction 'such that the maintenance of the suit does not offend "traditional notions of fair play and substantial justice."'" *Quill*, 504 U.S. at 307, 112 S.Ct. at 1910 (quoting *International Shoe Co. v. Washington*, 326 U.S. 310, 316, 66 S.Ct. 154, 158, 90 L.Ed. 95 (1945)). The Corporations argue that they have no "definite link" or "minimum connection" with Kentucky. However, as with our Commerce Clause analysis, we hold that the Corporations' ownership interest in, and receipt of income from, a partnership doing business in Kentucky provides the requisite link for taxation under the Due Process Clause. *Accord Borden Chemicals & Plastics, L.P.*, 726 N.E.2d at 78-79.

Apportionment

The Cabinet argues that since the circuit court concluded that the Corporations were subject to

taxation pursuant to KRS 141.206(5), it should have used the single-factor formula found therein to calculate the amount owed. Instead, the circuit court applied the three-factor formula found in KRS 141.120(8). We agree that KRS 141.206(5) contains the proper apportionment formula.

The circuit court held that the three-factor formula found in KRS 141.120(8) provided the correct method for calculating the taxes the Corporations owed, as that method "seems to be logical from a legal standpoint. To prevent the [Corporations] from applying this method, would possibly infringe on the [Corporations'] constitutional rights." Thus, the circuit court concluded not that the legislature intended for taxpayers to use the three-factor formula in situations such as these, but instead that prohibiting taxpayers from using the three-factor formula would subject the formula to possible constitutional problems. We disagree with the circuit court's reasoning.

"The cardinal rule of statutory construction is to ascertain and give effect to the intent of the legislature." *Ky. Ins. Guar. Ass'n v. Jeffers ex rel. Jeffers*, 13 S.W.3d 606, 610 (Ky. 2000). As set forth above, KRS 141.206(5) provides that nonresident corporations "are taxable on their proportionate share of the distributive income passed through the partnership . . . attributable to business done in Kentucky" if they are partners in a partnership "which does business within and without Kentucky[.]" Further, KRS 141.206(5)(a) provides: "Business done in Kentucky is determined by the ratio

of gross receipts from sales to purchasers or customers in Kentucky or services performed in Kentucky to the total gross receipts from sales or service everywhere." The plain language of these provisions compels a finding that the legislature intended for the amount of tax owed under this section to be calculated using the formula found therein. Accordingly, the circuit court erred by applying instead the formula found in KRS 141.120(8).

The question then becomes whether the application of this formula to the matter *sub judice* is constitutional. The Supreme Court explained in *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 164, 103 S.Ct. 2933, 2939-40, 77 L.Ed.2d 545 (1983):

> Under both the Due Process and the Commerce Clauses of the Constitution, a state may not, when imposing an income-based tax, "tax value earned outside its borders." In the case of a more-or-less integrated business enterprise operating in more than one State, however, arriving at precise territorial allocations of "value" is often an elusive goal, both in theory and in practice. For this reason and others, we have long held that the Constitution imposes no single formula on the States, and that the taxpayer has the "distinct burden of showing by 'clear and cogent evidence' that [the state tax] results in extraterritorial values being taxed . . . ."

(Internal citations omitted.) Here, the application of the formula found in KRS 141.206(5) will not result in

extraterritorial values being taxed, as the provision requires taxation of the "proportionate share of the distributive income passed through the partnership . . . attributable to business done in Kentucky." Again, "[b]usiness done in Kentucky is determined by the ratio of gross receipts from sales to purchasers or customers in Kentucky or services performed in Kentucky to the total gross receipts from sales or service everywhere." KRS 141.206(5)(a). This necessarily excludes extraterritorial values.

The Corporations argue that we should remand, directing the Board to admit into evidence and consider a tax expert's opinion regarding which formula to apply. However, we believe that the Board's error, if any, in failing to admit this evidence was harmless. First, the Board never reached the issue of which formula should apply since it held that the Corporations did not have the appropriate nexus with Kentucky. Second, the tax expert essentially opined that the three-factor formula is preferable from a policy perspective because it accounts for two key business inputs that the single-factor formula does not. Nevertheless, this court's role is not to decide policy. Rather, it is to "ascertain and give effect to the intent of the legislature." *Ky. Ins. Guar. Ass'n*, 13 S.W.3d at 610.

Payment Motion

Finally, the Cabinet argues that the circuit court erred by granting the Corporations' motion seeking immediate payment of their refunds. We agree.

Under KRS 131.365 and KRS 134.580, a refund payment is not due immediately. KRS 131.365(4) directs that payment shall be ordered on appeal. This section provides: "In the case of any appeal, any taxes, interest, or penalty paid but found by the board to be in excess of that legally due shall be ordered refunded to the taxpayer." The Cabinet argues that this statute is silent regarding the timing of any payment; however, we hold that the plain language directs that any payment shall be ordered upon appeal.

KRS 134.580(2) provides:

> When money has been paid into the State Treasury in payment of any state taxes, except ad valorem taxes, whether payment was made voluntarily or involuntarily, the appropriate agency shall authorize refunds to the person who paid the tax, or to his heirs, personal representatives or assigns, of any overpayment of tax and any payment where no tax was due. When a bona fide controversy exists between the agency and the taxpayer as to the liability of the taxpayer for the payment of tax claimed to be due by the agency, the taxpayer may pay the amount claimed by the agency to be due, and if an appeal is taken by the taxpayer from the ruling of the agency within the time provided by KRS 131.340 and it is finally adjudged that the taxpayer was not liable for the payment of the tax or any part thereof, the agency shall

> authorize the refund or credit as the Kentucky Board of Tax Appeals or courts may direct.

A refund payment under this statute is not due until the matter is "finally adjudged" by either the Board or a court. Thus, pursuant to these two statutes, the Corporations are not entitled to immediate payment of any refund.

The Bills

The Corporations assert that the Bills are invalid because they unconstitutionally and retroactively deprive the Corporations of interest on their tax refunds and/or claims. We disagree.

The Bills amended KRS 131.183, 141.044, 141.235 and 134.580 to provide, in part, that for tax refunds issued after a certain date, interest may begin to accrue as late as the date of filing an amended return, and at a rate of "prime minus 2%." The Bills also provide that these changes apply "retroactively on all outstanding refund claims for taxable years ending before December 31, 1995, and shall apply to all claims for such taxable years pending in any judicial or administrative forum." For numerous reasons, discussed below, the Corporations challenge the Bills' validity, including, but not limited to their contention that the Bills deprive them of interest on their overpayment for the interim period between the payment of the tax, or the due date of the return, and the date of filing the amended return, and that the retroactive effect of the Bills is unconstitutional.

First, the Corporations argue that the Bills are unconstitutional under due process provisions of federal and state law. In particular, the Corporations argue that they are constitutionally entitled to refunds on any overpayments of tax, and that interest constitutes part of the overpayment which must also be refunded. They claim not only that the Bills improperly deprive them of interest on their overpayments for up to four years, but also that the retroactively payable interest rate was improperly reduced to prime rate minus 2%.

Regardless of whether interest is considered part of an overpayment of tax, "[t]ax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code." *United States v. Carlton*, 512 U.S. 26, 33, 114 S.Ct. 2018, 2023, 129 L.Ed.2d 22 (1994). Neither is there a vested right in Title XI[5] of KRS, relating to Revenue and Taxation. Justice Stone explained in *Welch v. Henry*, 305 U.S. 134, 146-47, 59 S.Ct. 121, 125, 83 L.Ed. 87 (1938):

> Taxation is neither a penalty imposed on the taxpayer nor a liability which he assumes by contract. It is but a way of apportioning the cost of government among those who in some measure are privileged to enjoy its benefits and must bear its burdens. Since no citizen enjoys immunity from that burden, its retroactive imposition does not necessarily infringe due process[.]

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5. KRS Chapters 131 to 144.

Appendix A

The Supreme Court "repeatedly has upheld retroactive tax legislation against a due process challenge." 512 U.S. at 30, 114 S.Ct. at 2021. As long as retroactive application of the Bills to the statutes is "rationally related to a legitimate legislative purpose," due process is not violated. *Id.* at 35, 114 S.Ct. at 2024. Retroactive application of tax legislation has been held to be rationally related to the legitimate governmental purpose of raising revenue, in order to prevent a "significant and unanticipated revenue loss." *Id.* at 32, 114 S.Ct. at 2023.

The issue then is whether retroactive application of the Bills rationally furthers the legitimate governmental purpose of raising revenue, to prevent a significant and unanticipated revenue loss. The Corporations argue that the fiscal notes to both Bills indicate that the Bills are to have no fiscal impact on the Commonwealth and thus, raising revenue could not have been the purpose of the Bills. However, while the Bills may not expressly state their expected fiscal impact, such an omission is not dispositive to the determination of whether the Bills rationally further the purpose of raising revenue.

"Revenue raising is certainly a legitimate legislative purpose, and any law that retroactively adds a tax, removes a deduction, or increases a rate rationally furthers that goal." *Id.* at 40, 114 S.Ct. at 2027. (Scalia, J., concurring) (internal citations omitted). The Bills at issue herein have the effect of potentially shortening the time period for which a taxpayer may accrue interest on an overpayment of tax, and decreasing the rate at which said interest accrues---effects clearly intended to

increase revenue for the Commonwealth. Since the Bills rationally further the legitimate governmental purpose of raising revenue, we hold that they satisfy the "rational basis" test articulated in *Carlton*.

The Corporations also contend that the four-year period of retroactivity in this case fails to meet the "modesty requirement" of retroactive tax legislation under *Carlton*. However, contrary to the Corporations' assertion, the holding in *Carlton* did not establish such a "modesty requirement;" rather, the majority simply noted with favor that "Congress acted promptly and established only a modest period of retroactivity." *Id.* at 32, 114 S.Ct. at 2023. This suggests to us that the period of retroactivity is to be considered in determining whether the legislation rationally furthers a legitimate governmental purpose. Here, the Bills retroactively applied to all outstanding refund claims for taxable years ending prior to the Bills'effective dates, and to all claims for those taxable years pending in any judicial or administrative forum. We hold that the retroactive period extending to outstanding claims as of the Bills' effective dates does not violate the due process clause.

Second, the Corporations claim that the Bills violate equal protection provisions of federal and state law because their effective dates treat similarly situated taxpayers differently.[6] In other words, the Corporations

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6. The Fourteenth Amendment to the United States Constitution requires persons who are similarly situated to be treated alike. *Durham v. Peabody Coal Co.*, 272 S.W.3d 192, 195 (Ky. 2008) (citing *City of Cleburne, Tex. v. Cleburne Living Ctr.*, 473 U.S. 432, 439, 105 S.Ct. 3249, 3254, 87 L.Ed.2d 313, 320 (1985)).

assert that taxpayers who receive refunds after the effective dates will receive interest for a shorter period of time, and calculated at a lower rate, than taxpayers who received refunds prior to these dates.

Germane to the Corporations' claim is the well-established power of the government to tax and to enact legislation which controls the revenue system. "The broad discretion as to classification which a legislature possesses in the field of taxation has long been recognized." *Commonwealth, Revenue Cabinet v. Smith*, 875 S.W.2d 873, 875 (Ky. 1994). "Further, in a taxation case, unless a rational basis for such law can be completely refuted, then the law may stand as constitutional." *Id.*

"Statutes are presumed to be valid and those concerning social or economic matters generally comply with federal equal protection requirements if the classifications that they create are rationally related to a legitimate state interest." *Durham v. Peabody Coal Co.*, 272 S.W.3d 192, 195 (Ky. 2008) (citing *City of Cleburne, Tex. v. Cleburne Living Ctr.*, 473 U.S. 432, 440, 105 S.Ct. 3249, 3254, 87 L.Ed.2d 313, 320 (1985)). "A statute complies with Kentucky equal protection requirements if a 'reasonable basis' or 'substantial and justifiable reason' supports the classifications that it creates." *Durham*, 272 S.W.3d at 195 (quoting *Elk Horn Coal Corp. v. Cheyenne Res., Inc.*, 163 S.W.3d 408 (Ky. 2005)); *Waggoner v. Waggoner*, 846 S.W.2d 704 (Ky. 1992). This "rational basis" test is the same for due process, as discussed above, and again, the Bills satisfy its

requirements. Consequently, the Corporations' equal protection claim is without merit.

Third, the Corporations argue that application of the Bills constitutes an unconstitutional "taking" of the Corporations' interest in their refund claims and tax overpayments under the Fifth Amendment to the United States Constitution, the takings clause, and Ky. Const. § 13.[7]

> [I]t is . . . well settled that [the due process] clause [of the 5th Amendment] is not a limitation upon the taxing power conferred upon Congress by the Constitution; in other words, that the Constitution does not conflict with itself by conferring, upon the one hand, a taxing power, and taking the same power away, on the other, by the limitations of the due process clause. And no change in the situation here would arise even if it be conceded, as we think it must be, that this doctrine would have no application in a case where, although there was a seeming exercise of the taxing power, the act complained of was so arbitrary as to constrain to the conclusion that it was not the exertion of taxation, but a

7. The Fifth Amendment provides: "nor shall private property be taken for public use, without just compensation." Ky. Const. § 13 provides: "nor shall any man's property be taken or applied to public use without the consent of his representatives, and without just compensation being previously made to him."

> confiscation of property; that is, a taking of the same in violation of the 5th Amendment; or, what is equivalent thereto, was so wanting in basis for classification as to produce such a gross and patent inequality as to inevitably lead to the same conclusion.

Brushaber v. Union Pac. R.R., 240 U.S. 1, 24-25, 36 S. Ct. 236, 244, 60 L. Ed. 493, T.D. 2290 (1916) (holding, in part, that the retroactive effect of certain income tax provisions, fixing an earlier date as the time from which the income was to be computed, did not violate the due process clause of Fifth Amendment.); *see A. Magnano Co. v. Hamilton*, 292 U.S. 40, 44, 54 S.Ct. 599, 601, 78 L.Ed. 1109 (1934) (The due process clause "is applicable to a taxing statute . . . only if the act be so arbitrary as to compel the conclusion that it does not involve an exertion of the taxing power, but constitutes, in substance and effect, the direct exertion of a different and forbidden power, as, for example, the confiscation of property."). Here, the adjustment of the interest rate on tax refunds is not such an exertion of the legislative taxing power so as to constitute a "taking" of property for public use. Thus, the Corporations argument in this respect fails.

Fourth, the Corporations assert that the Bills violate Ky. Const. § 51, which provides, in pertinent part: "No law enacted by the General Assembly shall relate to more than one subject, and that shall be expressed in the title[.]" Specifically, the Corporations contend that the Bills' title "An act relating to fiscal matters and declaring

an emergency" contains more than one subject and insufficiently expresses the subject matter contained therein.

In *Commonwealth ex rel. Armstrong v. Collins*, 709 S.W.2d 437, 443 (Ky. 1986), the Kentucky Supreme Court confirmed that the portion of § 51 cited above permits a legislative act to pertain to only a single subject, which must be described in the act's title. Nevertheless, this section of the Constitution "has always been liberally construed, with all doubts being resolved in favor of the validity of the legislative action." *Id.* "The purpose of the section is said to be to prevent the enactment of 'surreptitious' legislation." *Id.* (citing *Bowman v. Hamlett*, 159 Ky. 184, 188, 166 S.W. 1008, 1009 (1914); *Dawson v. Commonwealth, Dep't of Transp.*, 622 S.W.2d 212 (Ky. 1981)).

In *E. Ky. Coal Lands Corp. v. Commonwealth*, 127 Ky. 667, 702-03, 106 S.W. 260, 271, 108 S.W. 1138, 32 Ky. L. Rptr. 129, 33 Ky. L. Rptr. 49 (1907), the court held that the title "A act relating to revenue and taxation" did not violate § 51, reasoning that "'[n]one of the provisions of a statute should be regarded as unconstitutional, where they all relate directly or indirectly to the same subject, have an natural connection, and not foreign to the subject expressed in its title.'" *Id.* (quoting *Phillips v. Cin. & Cov. Bridge Co.*, 59 Ky. (2 Met.) 219 (1859)). "In *L. & O. Turnpike Co. v. Ballard*, 59 Ky. (2 Met.) 165 (1859), it was said: 'A more liberal construction of this clause of the Constitution will be not only more consistent with the objects intended

to be accomplished by it, but will be found necessary in the practical business of legislation.'" *E. Ky. Coal*, 127 Ky. at 703-04, 106 S.W. at 271.

Here, the Corporations do not contend that the Bills contain surreptitious legislation; rather, they take issue with the title itself. However, under a liberal construction historically afforded to § 51, we hold that the portions of the Bills at issue herein, relating to tax refunds, properly fall within the category of "fiscal matters" and thus, the title of the Bills sufficiently express the subject matter contained therein.

Lastly, the Corporations aver that the Bills are impermissible special legislation in violation of Ky. Const. § 59, which prohibits the General Assembly from passing local or special acts concerning various subjects, including "To regulate the rate of interest." The Corporations argue that the Bills arbitrarily treat taxpayers who received refunds prior to the effective dates differently from those who will receive refunds after those dates, and disproportionately classify interest rates for refunds and assessments, for no distinct or natural reason.

"Classification is a necessary feature and power of legislation, as it is impossible for any extensive code of laws to apply to every person or subject in the state." *City of Louisville v. Commonwealth*, 134 Ky. 488, 496, 121 S.W. 411, 413 (1909). In *Ravitz v. Steurele*, 257 Ky. 108, 120, 77 S.W.2d 360, 366 (1934), the court held constitutional an act which "provides an extensive,

efficient system for the control, regulation, and the general supervision of the class of money lenders embraced by it." In so ruling, the court reasoned that the act's "intendment and purpose is to control, regulate, and supervise the business of the money lenders classified by it, and, in so far as it deals with the subject of interest, it does so incidentally and as a part of the system of regulation and control therein provided." *Id.* Thus, "[a]s its provisions relate to interest, it is not a local or special law[.]" *Id.*

By the same token, insofar as the Bills at issue herein deal with the subject of interest, they do so incidentally and as part of a system of controlling, regulating, and supervising tax refunds. The effective dates, after which taxpayers are susceptible to different interest rates, are neither arbitrary nor unreasonable, and do not undertake in any way to fix or regulate the rate of interest. Thus, the challenged portions of the Bills herein are not impermissible special legislation in violation of Ky. Const. § 59 with respect to regulating the rate of interest.

The Franklin Circuit Court's order is affirmed in part, reversed in part, and remanded for further proceedings.

ALL CONCUR.

APPENDIX B — ORDER NO. K-19449 AND FINDINGS OF FACT, CONCLUSIONS OF LAW AND FINAL ORDER, COMMONWEALTH OF THE KENTUCKY BOARD OF TAX APPEALS DATED JANUARY 27, 2006

COMMONWEALTH OF KENTUCKY
KENTUCKY BOARD OF TAX APPEALS
FILE NUMBERS K00-R-31, K02-R-30,
K02-R-31 AND K02-R-32

ASWORTH CORPORATION, HT-FORUM, INC. (N/K/A HTF, LLC) AND D AVIATION SERVICES, INC. (N/K/A D AVIATION SERVICES, LLC)

APPELLANT

v.

REVENUE CABINET (N/K/A FINANCE AND ADMINISTRATION CABINET, DEPARTMENT OF REVENUE), COMMONWEALTH OF KENTUCKY

APPELLEE

ORDER NO. K-19449

After consideration of all evidence presented at the hearing on October 12, 2005 and having reviewed the case including briefs, proposed finding of fact and conclusions of law and being otherwise sufficiently advised, the Kentucky Board of Tax Appeals hereby enters the following findings of fact, conclusions of law and order:

Appendix B

FINDINGS OF FACT, CONCLUSIONS OF LAW AND FINAL ORDER

This matter was brought before the Kentucky Board of Tax Appeals by petition of ASWORTH CORPORATION. Consolidated with that petition were similar appeals by HT-FORUM, INC. (N/K/A HTF, LLC) and D AVIATION SERVICES, INC. (N/K/A D AVIATION SERVICES LLC). It was stipulated that all issues arising in the ASWORTH appeal are common to all other APPELLANTS. As such all similarly situated parties will be referred to herein jointly as APPELLANT.

APPELLANT'S petition raised several issues regarding the final ruling of the REVENUE CABINET (N/K/A FINANCE AND ADMINISTRATION CABINET, DEPARTMENT OF REVENUE) COMMONWEALTH OF KENTUCKY, referred to herein as THE DEPARTMENT. By agreement and/or stipulation many of the issues raised in the petition were resolved between the parties during the morning session of the hearing in this matter held in Frankfort before the full board on October 12, 2005.

With the generous assistance of counsel for both parties nearly all facts necessary for a determination of the issues in this case were agreed to or stipulated.

Of particular significance THE DEPARTMENT, through counsel, stipulated that the APPELLANT was, at all relevant times a foreign corporation. THE

DEPARTMENT also stipulated that APPELLANTS sole connection with the Commonwealth was its receipt of a distributive share of partnership income received from the profits of variously named and organized partnerships doing business in Kentucky.

THE DEPARTMENT also stipulated that during the tax periods at issue in this case a "substantial nexus" with Kentucky was required in order for the Commonwealth to collect an income tax on foreign corporations.

While THE DEPARTMENT stipulated that THE APPELLANT had no "physical presence" in the Commonwealth THE DEPARTMENT took the position that "physical presence" was not required in order for Kentucky to impose income tax on THE APPELLANT. THE DEPARTMENT argued that THE APPELLANT'S receipt of a "partnership distributive share" from an entity doing business in Kentucky was enough to satisfy the "substantial nexus" test.

APPELLANT argues that the imposition of income tax on foreign corporations during the periods in question was limited to those foreign corporations "owning or leasing property located in this state or having one (1) or more employees receiving compensation . . . in this state". KRS 141.040. Because THE DEPARTMENT agreed that APPELLANT did not meet this test APPELLANT argues that it was not subject to income taxes.

APPELLANT also advanced the argument that before Kentucky can constitutionally impose an income tax on foreign corporations a "physical presence" is necessary in order to satisfy the constitutionally required "substantial nexus" test.

The parties also argued that should the Board decide that THE APPELLANT was subject to corporate income tax that either a "single prong" test (THE DEPARTMENT'S position) or a "three prong" test (THE APPELLANT'S position) for apportionment should be applied in calculating that tax. Because we find that a much narrower issue is dispositive of this case, we do not reach this or the other issues presented for consideration.

FINDINGS OF FACT

Based upon the stipulations and agreements of the parties in the record of this matter the Board makes the following FINDINGS OF FACT.

1. THE APPELLANT is a foreign corporation.

2. THE APPELLANT had no "physical presence" in Kentucky during the relevant tax periods.

3. THE APPELLANT received a distributive share of income from partnership entities doing business in Kentucky during the relevant tax periods and this was THE APPELLANT'S sole connection with Kentucky.

4. THE APPELLANT neither owned nor leased property in Kentucky nor had one or more employees receiving compensation in Kentucky during the relevant tax periods.

CONCLUSIONS OF LAW

Based upon the entire record and the FINDINGS OF FACT made above, the Board makes the following CONCLUSIONS OF LAW.

During the relevant tax periods the Kentucky Legislature imposed a tax upon foreign corporations owning or leasing property in this state or which had one or more employees receiving compensation in this state. KRS 141.040. During these periods Kentucky did not impose a tax on partnerships.

Because THE APPELLANTS did not own or lease property in Kentucky or have one or more employees receiving compensation here the clear and unambiguous language of KRS 141.040 did not reach the distributive share paid to them by partnerships doing business in the Commonwealth.

Because we believe that it is our function to consider the narrowest issue which is dispositive of this controversy we need not address the other issues raised by these appeals.

Appendix B

ORDER

IT IS HEREBY ORDERED that the APPELLANTS are relieved of the taxes, penalties and interest which are the subject of this appeal and entitled to all other relief afforded by statute for the collection and enforcement of this order.

This is a final and appealable order. All final orders of this agency shall be subject to judicial review in accordance with the provisions of KRS Chapter 13B. A party shall institute an appeal by filing a petition in the Circuit Court of venue, as provided in the agency's enabling statutes, within thirty (30) days after the final order of the agency is mailed or delivered by personal service. If venue for appeal is not stated in the enabling statutes, a party may appeal to Franklin Circuit Court or the Circuit Court of the county in which the appealing party resides or operates a place of business. Copies of the petition shall be served by the petitioner upon the agency and all parties of record. The petition shall include the names and addresses of all parties to the proceeding and the agency involved, and a statement of the grounds on which the review is requested. The petition shall be accompanied by a copy of the final order.

A party may file a petition for judicial review only after the party has exhausted all administrative remedies available within the agency whose action is being challenged, and within any other agency authorized to exercise administrative review.

Appendix B

A petition for judicial review shall not automatically stay a final order pending the outcome of the review, unless:

(a) An automatic stay is provided by statute upon appeal or at any point in the administrative proceedings;

(b) A stay is permitted by the agency and granted upon request; or

(c) A stay is ordered by the Circuit Court of jurisdiction upon petition.

Within twenty (20) days after service of the petition of appeal, or within further time allowed by the Circuit Court, the Kentucky Board of Tax Appeals shall transmit to the reviewing court the original or a certified copy of the official record of the proceeding under review in compliance with KRS 13B.140(3).

DATE OF ORDER
AND MAILING: January 27, 2006

KENTUCKY BOARD OF TAX APPEALS
FULL BOARD CONCURRING

s/Nancy Mitchell

NANCY MITCHELL
CHAIR

APPENDIX C — ORDER OF THE COMMONWEALTH OF KENTUCKY FRANKLIN CIRCUIT COURT DIVISION II DATED DECEMBER 4, 2007

COMMONWEALTH OF KENTUCKY
FRANKLIN CIRCUIT COURT
DIVISION II
CIVIL ACTION NO. 06-CI-00288

REVENUE CABINET (N/K/A FINANCE AND ADMINISTRATION CABINET, DEPARTMENT OF REVENUE), COMMONWEALTH OF KENTUCKY

APPELLANT

v.

ASWORTH CORPORATION (N/K/A ASWORTH, LLC), HT-FORUM, INC (N/K/A HTF, LLC) AND D AVIATION SERVICES, INC. (N/K/A D AVIATION SERVICES, LLC)

APPELLEES

ORDER

This action is back before the Court on the Motion of the Appellees to alter, amend or vacate (the "Motion") the Court's Order of June 14, 2007 (the "Order"). This motion must be granted, at least in part, for the following reasons:

Appendix C

The Court, in its Order, originally ordered the case to be remanded to the Kentucky Board of Tax Appeals (the "Board") for a determination of the amount of the refund due in light of the holdings in the Order, specifically that the Appellees did not prevail on their nexus argument, but did prevail on their apportionment argument. The parties have in fact stipulated to that amount, and therefore, there is no need to remand this case to the Board for a finding on this issue. As a result this conclusion was incorrect.

In addition, because there is no need to remand the case, it is appropriate to address other legal issues that were not addressed in the Order, specifically, the Commerce Clause and Due Process arguments, as well as Appellees' Motion to Direct Appellant to Refund Taxes, Penalties, Costs, Fees and Interest (the "Payment Motion"), and to add finality language.

As a result, the Court hereby grants the Motion, to the extent that (i) remand to the Board is not needed to determine the amount of refund due if Appellees have nexus with Kentucky but are entitled to apportionment, (ii) the Commerce Clause and Due Process Clause issues and the Payment Motion should be addressed in an order and (iii) finality language should be added. The remaining relief sought in Appellees' Motion is hereby denied.

In accordance with this ruling the Order is hereby amended and restated in its entirety to read as follows:

Appendix C

This matter is before the Court upon an appeal from the Kentucky Board of Tax Appeals (the "Board"). The Appellant Revenue Cabinet (Finance & Administration Cabinet, Department of Revenue, Commonwealth of Kentucky) ("Revenue") appeals Board Order No. K-19449 which held that the Appellees (primarily "Asworth") were not subject to Kentucky corporation income tax. The Board based its Order on the fact that the Appellees did not own or lease property in Kentucky, nor have any employees in Kentucky, pursuant to the requirements of KRS 141.040. The Court has reviewed the record, arguments of counsel and all applicable law and now **REVERSES** the Order of the Board.

The facts reveal that this case involves tax years dating back to 1993. The actual years in contention involve taxable periods ending January 31, 1993 through January 31, 1996. Asworth initially owned a 99% limited partnership interest in Conwood Company, LP ("Conwood"), a Delaware limited partnership which conducted business both within and outside Kentucky.[1]

For the taxable periods ending January 31, 1993 through January 31, 1996, Appellees filed Kentucky corporation income tax returns and paid Kentucky corporation income tax calculated by including property,

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[1] Asworth's corporate structure changed between November 1, 1996 through April 30, 1997 as (1) Asworth contributed 1% of its limited partnership interest in D Aviation Services, Inc., n/k/a D Aviation Services LLC ("D Aviation"), (2) GP Corporation merged with Asworth, who acquired GP Corporation's 1% general partnership interest in Conwood, and (3) Asworth converted 51% of its limited partnership interest in Conwood into a general partnership interest.

(Cont'd)

payroll and receipts of both Asworth and Conwood. Appellee utilized the three-factor, sales double-weighted apportionment method in calculating this tax payment.

Revenue conducted a corporation income tax audit of Asworth for taxable years ending January 31, 1993 thru January 31, 1996. At the end of the audit, Revenue assessed Asworth an additional $654,629 income tax liability, plus applicable interest and penalties. This

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(Cont'd)

Asworth thereafter contributed its 47% limited partnership interest in Conwood to HT-Forum, Inc., n/k/a HTF, LLC ("HTF", Asworth, HTF and D Aviation are collectively referred to as "Appellees" or "Taxpayers") and Conwood Sales Company ("Conwood Sales"), a Delaware limited partnership that does business within and without Kentucky, was formed. In return for this contribution, each partner of Conwood received an identical ownership interest in Conwood Sales.

On November 15, 1996, Asworth contributed 1% of its limited partnership interest in Conwood to D Aviation. Asworth contributed its limited partnership interests in Conwood and Conwood Sales to D Aviation on April 30, 1997, and D Aviation changed its tax year end to December 31, effective with the tax year ending December 31, 1997. Additional structural changes occured from May 1, 1997 through December 31, 1999.

The Taxpayers subsequently filed additional refund claims based on their assertion that they had no nexus with Kentucky, as their only connection with Kentucky was through their partnership interests in Conwood and Conwood Sales. These refund claims were also denied by Revenue. Revenue ultimately issued three more final rulings that Asworth appealed to the Board, which then consolidated the four final rulings into a single action. A hearing was held on October 12, 2005.

additional assessment was based on Revenue's assertion that the correct apportionment method, pursuant to KRS 141.206(5), is a single-factor receipt method — on Conwood receipts in Kentucky over Conwood receipts everywhere. Asworth elected to not protest this assessment and as a result, paid the $654,629, plus applicable penalties and interest. Asworth then filed a refund claim for both this amount and the prior amount paid when the returns were originally filed. The additional amount of the refund claim was based on Asworth's argument that it had no nexus with Kentucky, as its only connection with Kentucky was through its partnership interest in Conwood. In the alternative, Asworth asserted that its original filing method was correct, and that the single-factor receipts method should not be used. Revenue denied the refund claims and asserted that Asworth was subject to Kentucky corporation income tax on its distributive share of income from Conwood pursuant to KRS 141.206. Revenue ultimately issued a final ruling which Asworth then appealed to the Board. The Board agreed with Asworth, holding that the taxpayers were not subject to Kentucky corporation income tax pursuant to KRS 141.040. This appeal ensued.

In reviewing an agency decision, this Court may only overturn that decision if the agency acted arbitrarily or outside the scope if its authority, if the agency applied an incorrect rule of law, or if the decision itself is not supported by substantial evidence. *Kentucky State Racing Comm'n v. Fuller*, 481 S.W.2d 298, 300-301 (Ky. 1972). If the Court finds the correct rule of law

was applied to facts supported by substantial evidence, the final order of the agency must be affirmed. *Brown Hotel Company v. Edwards*, 356 S.W.2d 299, 302 (Ky. 1963). When the outcome of a case turns on an issue of law, as in the instant matter, appellate review is *de novo*. *Western Kentucky Coca-Cola Bottling Co., Inc. v. Revenue Cabinet*, 80 S.W.2d 787, 790 (2001). There is no requirement that the Court grant any deference to (administrative agency) where factual findings are not at issue. *Id.*

The Court's standard of review of the Board decision, an administrative determination, is primarily that of determining the property of "questions of law." *See Epsilon Trading Co. v. Revenue Cabinet*, 775 S.W.2d 937, 946 (Ky. App. 1989); *Revenue Cabinet v. Moors Resort, Inc.*, 675 S.W.2d 859 (Ky. App. 1984); *see also Williams v. Cumberland Valley Nat'l Bank*, 569 S.W.2d 711 (Ky. App. 1978) (holding that in general the judicial review of an administrative agency's actions should ensure that the agency has not acted arbitrarily).

The parties each agree that the matter before the Court involves a question of law and no factual issues are in dispute. The Order of January 27, 2006 of the Board of Tax Appeals found that there was no nexus by Appellees to the Commonwealth of Kentucky. To arrive at this conclusion, the Board of Tax Appeals would have to apply KRS 141.040 without acknowledging the existence of KRS 141.206. The Court agrees with the Appellant, Revenue Cabinet, that KRS 141.206 is an imposition statute. The Court also agrees that Asworth

has sufficient nexus, or contacts, with the State of Kentucky for taxing purposes.

Appellees are subject to tax on their distributive share income from partnerships doing business both within and without Kentucky pursuant to KRS 141.206. The Board erred in failing to address this issue in its Order. KRS 141.206 imposes income tax on individuals and corporations that carry on a business as partners in a partnership doing business in Kentucky. If a corporation has no property and payroll in Kentucky, but is a partner doing business in Kentucky, KRS 141.206 is the governing statute. The partnership pays no income tax; instead its partners are taxed on their distributive share of income attributable to the partnership doing business in Kentucky. KRS 141.206. Specifically, KRS 141.206(3) provides:

> Individuals or corporations carrying on business as a partnership or S corporation shall be liable for income tax only in their individual or corporate capacities, and no income tax shall be assessed upon the income of any partnership or S corporation except as prescribed in KRS 141.040(5).

KRS 141.206(3)(b) provides:

> Corporations which are partners must include their distributive share of net income, gain, loss, deduction or credit, as determined under subsection (2) of this section, except as provided in subsections (4) and (5) of this section.

Appendix C

KRS 141.206(5) provides:

> Nonresident individuals and corporations which are partners in a partnership or shareholders in an S corporation which does business within and without Kentucky are taxable on their proportionate share of the distributive income passed through the partnership or S corporation attributable to business done in Kentucky.
>
> (a) Business done in Kentucky is determined by the ratio of gross receipts from sales to purchases in Kentucky or sales performed in Kentucky to the total gross receipts form sales or service everywhere.

To summarize, KRS 141.206 recognizes the flow-thru nature of partnerships, and accordingly states that the income tax is not owed by the partnership, but rather imposes the income tax upon the partners. Moreover, the term "nonresident: has been consistently interpreted by Revenue, for purposes of KRS 141.206, to mean a corporation who is neither a Kentucky corporation nor a non-Kentucky corporation with property and payroll in Kentucky. Corporation Income tax is owed by Asworth.

CONSTITUTIONAL ISSUES

With respect to Asworth's Commerce Clause argument, the Commerce Clause requires that a tax

must be "applied to an activity with a substantial activity within the taxing state." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). There is currently no bright line physical presence standard with respect to income tax for the substantial nexus test of the Commerce Clause. *Quill Corp. v. North Dakota*, 504 U.S. 298, 317 (1992). The substantial nexus test of the Commerce Clause may be satisfied even if the taxpayer does not have a physical presence within the taxing state. *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993); *Borden Chemicals and Plastics, L.P. v. Ken Zehnder*, 726 N.E.2d 73 (Ill. App. 1st 2000). Asworth's derivation of income from their partnership interests in partnerships doing business both within and without Kentucky satisfies the substantial nexus test of the Commerce Clause, and as a result, Asworth is subject to Kentucky corporation income tax on their distributive share income.

Similarly, the Due Process Clause "requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." *Miller Bros. v. Maryland*, 347 U.S. 340, 344-45, 774 S. Ct. 535, 539 (1954). Here, the definite link or minimum connection is the Appellees' interest in partnerships that are doing business both within and without Kentucky, which has resulted in a substantial amount of distributive share income to Appellees from their partnerships' Kentucky activities. In addition, Appellees have purposefully directed their activities at Kentucky through their interest in Conwood and Conwood Sales. As a result, Appellees are constitutionally subject to

Kentucky corporation income tax on their distributive share income.

PROPER APPORTIONMENT METHOD

Having found taxes are applicable to Asworth, the next issue is whether the income subject to tax should be apportioned based upon the ratio of sales, property, and payroll in Kentucky to total sales, property, and payroll everywhere in the United States in order to accurately reflect income attributable to Kentucky. This Court rules that the three-factor method is the correct method of calculating taxes due to Appellant (See Exhibit C, Brief of Appellees). The three-factor apportionment seems to be logical from a legal standpoint. To prevent the Appellee from applying this method, would possibly infringe on the Appellees constitutional rights. The Court has found a minimum nexus and the Appellees should receive the benefit of the three-factor method. The Courts have long held that states are limited under the U.S. Constitution, to taxing only those amounts of income that bear a reasonable relationship to activities conducted in that sates. The Appellees are multi-state entities and should be fairly treated as such. *See Complete Auto Transit Inc. v. Brady*, 430 U.S. 274, 97 S. Ct 1076 (1977). KRS 141.120(8) [illegible] apportionment statute and KRS 141.[illegible] applicable for applying tax rates as Appellees are also multi-state corporations based in Delaware.

Appendix C

THE AMOUNT OF THE REFUND

The amount of the refund, based upon the Appellees prevailing upon the apportionment method, was stipulated to by the parties. The amount of the refund, based upon the apportionment method, with statutory interest accrued through August 31, 2007, is as follows: Asworth ($1,815,003.85 in tax and interest), HTF ($667,738.98 in tax and interest), and D Aviation ($5,975.73 tax and interest).

THE PAYMENT MOTION

In addition to the arguments raised on appeal, Asworth filed the Payment Motion, seeking payment of the refund immediately, rather than when this case is final and no longer on appeal. Asworth has indicated it is willing to post a bond equal to the amount of the payment sought.

The Court believes that such procedure as advanced by Asworth is correct and contemplated by KRS 131.370 (2) and KRS 131.365 (4).

Accordingly, the refunds memorialized in this Order, plus statutory interest pursuant to KRS 131.183

Appellees within fifteen (15) days of entry of this Order. The Ordered bond shall be in place no later than fifteen (15) days after such date of payment if either party seeks appellate review.

Appendix C

WHEREFORE, the Order of the Board of Tax Appeals is **REVERSED**, and the Motion to Alter, Amend, or Vacate is **GRANTED** in part and **DENIED** in part.

There being no just cause for delay, this is a final and appealable order.

SO ORDERED this 4th day of December, 2007.

/s/
Thomas D. Wingate, Judge
Franklin Circuit Court
Division II

DISTRIBUTION

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Laura M. Ferguson
Office of Legal Services in Support of Revenue
P.O. Box 423
Frankfort, KY 40602-0423

APPENDIX D— ORDER DENYING DISCRETIONARY REVIEW OF THE SUPREME COURT OF KENTUCKY FRANKLIN CIRCUIT COURT DATED AUGUST 18, 2010

SUPREME COURT OF KENTUCKY
FRANKLIN CIRCUIT COURT
2009-SC-0816-D
(2007-CA-2549 & 2008-CA-0023)

ASWORTH CORPORATION,
N/K/A ASWORTH, LLC, ET AL.

MOVANTS

V.

REVENUE CABINET, COMMONWEALTH OF KENTUCKY, N/K/A FINANCE & ADMINISTRATION CABINET, DEPARTMENT OF REVENUE

RESPONDENT

ORDER DENYING DISCRETIONARY REVIEW

The motion for review of the decision of the Court of Appeals is denied.

The opinion of the Court of Appeals is ordered not to be published.

ENTERED: August 18, 2010.

/s/
CHIEF JUSTICE

APPENDIX E — RELEVANT STATUTES
KENTUCKY REVISED STATUTES

TITLE XI. REVENUE AND TAXATION
CHAPTER 131. REVENUE CABINET
GENERAL PROVISIONS

KRS § 131.183 (Michie 1993)

§ 131.183. Tax interest rate

(1) All taxes payable to the Commonwealth not paid at the time prescribed by statute shall accrue interest at the tax interest rate. The tax interest rate for tax liabilities that are assessed on or after July 1, 1982, shall be sixteen percent (16%). This tax interest rate shall apply until January 1, 1983, when the tax interest rate shall be adjusted as provided in this section. The secretary of revenue shall adjust the tax interest rate not later than November 15 of any year, beginning in 1982, if the adjusted prime rate charged by banks during October of that year, rounded to the nearest full percent, is at least one (1) percentage point more or less than the tax interest rate which is then in effect. The tax interest rate shall be equal to the adjusted prime rate charged by banks rounded to the nearest full percent, and shall become effective on January 1 of the immediately succeeding year.

(2) Interest shall be allowed and paid upon any overpayment in respect of any of the taxes provided for in Chapters 131, 132, 134, 136, 137, 138, 139, 140, 141, 142, 143, 143A, and 243 of the Kentucky Revised Statutes at the rate provided in subsection (1) above.

Appendix E

Except for the provisions of KRS 138.351, 141.044(2), 141.235(3), and subsection (3) of this section, interest authorized under this subsection shall begin to accrue sixty (60) days after the due date of the return or the date the tax was paid, whichever is later, and in no case shall interest be paid in an amount less than five dollars ($5).

(3) Effective for refund claims filed on or after July 15, 1992, if any overpayment of the tax imposed under KRS Chapter 141 results from a carryback of a net operating loss or a net capital loss, the overpayment shall be deemed to have been made on the date the claim for refund was filed. Interest authorized under subsection (2) of this section shall begin to accrue ninety (90) days from the date the claim for refund was filed.

Appendix E

TITLE XI. REVENUE AND TAXATION
CHAPTER 131. REVENUE CABINET
GENERAL PROVISIONS

KRS § 131.183 (1998)

§ 131.183. Tax interest rate

(1) All taxes payable to the Commonwealth not paid at the time prescribed by statute shall accrue interest at the tax interest rate. The tax interest rate for tax liabilities that are assessed on or after July 1, 1982, shall be sixteen percent (16%). This tax interest rate shall apply until January 1, 1983, when the tax interest rate shall be adjusted as provided in this section. The secretary of revenue shall adjust the tax interest rate not later than November 15 of any year, beginning in 1982, if the adjusted prime rate charged by banks during October of that year, rounded to the nearest full percent, is at least one (1) percentage point more or less than the tax interest rate which is then in effect. The tax interest rate shall be equal to the adjusted prime rate charged by banks rounded to the nearest full percent, and shall become effective on January 1 of the immediately succeeding year.

(2) Interest shall be allowed and paid upon any overpayment in respect of any of the taxes provided for in Chapters 131, 132, 134, 136, 137, 138, 139, 140, 141, 142, 143, 143A, and 243 of the Kentucky Revised Statutes at the rate provided in subsection (1) above. Except for the provisions of KRS 138.351, 141.044(2),

141.235(3), and subsection (3) of this section, interest authorized under this subsection shall begin to accrue sixty (60) days after the due date of the return or the date the tax was paid, whichever is later, and in no case shall interest be paid in an amount less than five dollars ($5).

(3) Effective for refund claims filed on or after July 15, 1992, if any overpayment of the tax imposed under KRS Chapter 141 results from a carryback of a net operating loss or a net capital loss, the overpayment shall be deemed to have been made on the date the claim for refund was filed. Interest authorized under subsection (2) of this section shall begin to accrue ninety (90) days from the date the claim for refund was filed.

(4) No interest shall be allowed or paid on any sales tax refund as provided by KRS 139.536.

Appendix E

TITLE XI. REVENUE AND TAXATION
CHAPTER 134. PAYMENT, COLLECTION, AND REFUND OF TAXES

KRS § 134.580 (Michie 1993)

§ 134.580. "Agency" defined -- Refund of taxes, other than ad valorem and unconstitutional taxes

(1) As used in this section, unless the context requires otherwise, "agency" means the agency of state government which administers the tax to be refunded or credited.

(2) When money has been paid into the State Treasury in payment of any state taxes, except ad valorem taxes, whether payment was made voluntarily or involuntarily, the appropriate agency shall authorize refunds or credits to the person who paid the tax, or to his heirs, personal representatives or assigns, of any overpayment of tax and any payment where no tax was due. When a bona fide controversy exists between the agency and the taxpayer as to the liability of the taxpayer for the payment of tax claimed to be due by the agency, the taxpayer may pay the amount claimed by the agency to be due, and if an appeal is taken by the taxpayer from the ruling of the agency within the time provided by KRS 131.340 and it is finally adjudged that the taxpayer was not liable for the payment of the tax or any part thereof, the agency shall authorize the refund or credit as the Kentucky Board of Tax Appeals or courts may direct.

(3) Refunds or credits shall be authorized with interest as provided in KRS 131.183. The refunds authorized by this section shall be made in the same manner as other claims on the State Treasury are paid. They shall not be charged against any appropriation, but shall be deducted from tax receipts for the current fiscal year.

(4) Nothing in this section shall be construed to authorize the agency to make or cause to be made any refund except within four (4) years of the due date of the return or the date the money was paid into the State Treasury whichever is the later, except that, in any case where the assessment period has been extended by written agreement between the taxpayer and the cabinet, the limitation contained in this subsection shall be extended accordingly. Nothing in this section shall be construed as requiring the agency to authorize any refund or credit to a taxpayer without demand from the taxpayer, if in the opinion of the agency the cost to the state of authorizing the refund or credit would be greater than the amount that should be refunded or credited.

(5) The terms "overpayment" and "payment where no tax was due," as used in this section, shall be construed as referring to tax liability under the terms of the applicable statute without reference to the constitutionality of the statute. This section shall not apply to any case in which the statute may be held unconstitutional, either in whole or in part.

(6) In cases in which a statute has been held unconstitutional, taxes paid thereunder may be refunded to the extent provided by KRS 134.590, and by the statute held unconstitutional.

Appendix E

TITLE XI. REVENUE AND TAXATION CHAPTER 134. PAYMENT, COLLECTION, AND REFUND OF TAXES

KRS § 134.580 (Michie 1996)

§ 134.580. Refund of taxes, other than ad valorem and unconstitutional taxes

(1) As used in this section, unless the context requires otherwise:

(a) "Agency" means the agency of state government which administers the tax to be refunded or credited.

(b) "Overpayment" or "payment where no tax was due" means the tax liability under the terms of the applicable statute without reference to the constitutionality of the statute.

(2) When money has been paid into the State Treasury in payment of any state taxes, except ad valorem taxes, whether payment was made voluntarily or involuntarily, the appropriate agency shall authorize refunds or credits to the person who paid the tax, or to his heirs, personal representatives or assigns, of any overpayment of tax and any payment where no tax was due. When a bona fide controversy exists between the agency and the taxpayer as to the liability of the taxpayer for the payment of tax claimed to be due by the agency, the taxpayer may pay the amount claimed by the agency to be due, and if an appeal is taken by the taxpayer from

the ruling of the agency within the time provided by KRS 131.340 and it is finally adjudged that the taxpayer was not liable for the payment of the tax or any part thereof, the agency shall authorize the refund or credit as the Kentucky Board of Tax Appeals or courts may direct.

(3) Refunds or credits shall be authorized with interest as provided in KRS 131.183. The refunds authorized by this section shall be made in the same manner as other claims on the State Treasury are paid. They shall not be charged against any appropriation, but shall be deducted from tax receipts for the current fiscal year.

(4) Nothing in this section shall be construed to authorize the agency to make or cause to be made any refund except within four (4) years of the date prescribed by law for the filing of a return inlcuding any extension of time for filing the return, or the date the money was paid into the State Treasury, whichever is the later, except in any case where the assessment period has been extended by written agreement between the taxpayer and the cabinet, the limitation contained in this subsection shall be extended accordingly. Nothing in this section shall be construed as requiring the agency to authorize any refund or credit to a taxpayer without demand from the taxpayer, if in the opinion of the agency the cost to the state of authorizing the refund or credit would be greater than the amount that should be refunded or credited.

(5) This section shall not apply to any case in which the statute may be held unconstitutional, either in whole or in part.

(6) In cases in which a statute has been held unconstitutional, taxes paid thereunder may be refunded to the extent provided by KRS 134.590, and by the statute held unconstitutional.

Appendix E

TITLE XI. REVENUE AND TAXATION
CHAPTER 141. INCOME TAXES

KRS § 141.040 (Michie 1993)

§ 141.040. Corporation income tax -- Exemption -- Rate.

(1) Every corporation organized under the laws of this state, every corporation having its commercial domicile as defined in KRS 141.120(1)(b) in this state, and every foreign corporation owning or leasing property located in this state or having one (1) or more individuals receiving compensation as defined in KRS 141.120(8)(b) in this state, except those corporations listed in paragraphs (a) to (i) of this subsection, shall pay for each taxable year a tax to be computed by the taxpayer on taxable net income at the rates specified in subsections (2), (3), and (4) of this section:

(a) S corporations;

(b) State and national banks and trust companies, except bankers' banks organized under KRS 287.135;

(c) Savings and loan associations organized under the laws of this state and under the laws of the United States and making loans to members only;

(d) Banks for cooperatives;

(e) Production credit associations;

(f) Insurance companies, including farmers or other mutual hail, cyclone, windstorm, or fire insurance companies, insurers, and reciprocal underwriters;

(g) Corporations exempt under Section 501 of the Internal Revenue Code;

(h) Religious, educational, charitable, or like corporations not organized or conducted for pecuniary profit; and

(i) Corporations having no individuals receiving compensation as defined in KRS 141.120(8)(b) in this state, and whose only owned or leased property located in this state is located at the premises of a printer with which it has contracted for printing, if such property consists of the final printed product, property which becomes a part of the final printed product, or copy from which the printed product is produced.

(2) For tax years ending before January 1, 1990, the following rates shall apply:

(a) Three percent (3%) of the first twenty-five thousand dollars ($25,000) of taxable net income;

(b) Four percent (4%) of the amount of taxable net income in excess of twenty-five thousand dollars ($25,000), but not in excess of fifty thousand dollars ($50,000);

(c) Five percent (5%) of the amount of taxable net income in excess of fifty thousand dollars ($50,000), but not in excess of one hundred thousand dollars ($100,000);

(d) Six percent (6%) of the amount of taxable net income in excess of one hundred thousand dollars ($100,000), but not in excess of two hundred fifty thousand dollars ($250,000); and

(e) Seven and twenty-five one hundredths percent (7.25%) of the amount of taxable net income in excess of two hundred fifty thousand dollars ($250,000).

(3) For tax years beginning after December 31, 1989, the following rates shall apply:

(a) Four percent (4%) of the first twenty-five thousand dollars ($25,000) of taxable net income;

(b) Five percent (5%) of the amount of taxable net income in excess of twenty-five thousand dollars ($25,000) but not in excess of fifty thousand dollars ($50,000);

(c) Six percent (6%) of the amount of taxable net income in excess of fifty thousand dollars ($50,000), but not in excess of one hundred thousand dollars ($100,000);

(d) Seven percent (7%) of the amount of taxable net income in excess of one hundred thousand dollars ($100,000), but not in excess of two hundred fifty thousand dollars ($250,000); and

(e) Eight and twenty-five one hundredths percent (8.25%) of the amount of taxable net income in excess of two hundred fifty thousand dollars ($250,000).

(4) For tax years beginning before January 1, 1990, and ending after December 31, 1989, the tax shall be the sum of the amounts determined in paragraphs (a) and (b) as follows:

(a) Apply the tax rates in subsection (2) of this section to the taxable net income for the year and multiply the result by a fraction, the numerator of which is the number of days from the first day of the taxable year through December 31, 1989, and the denominator of which is the total number of days of the taxable year; and

(b) Apply the tax rates in subsection (3) of this section to the taxable net income for

the year and multiply the result by a fraction, the numerator of which is the number of days from January 1, 1990, through the last day of the taxable year and the denominator of which is the total number of days of the taxable year.

(5) Every S corporation shall pay the tax imposed under subsection (1) of this section whenever the net capital gain of such corporation exceeds twenty-five thousand dollars ($25,000), and exceeds fifty percent (50%) of its taxable income for the taxable year and its taxable income for such year exceeds twenty-five thousand dollars ($25,000). The tax imposed by this subsection shall be the lower of:

(a) The tax determined by applying the rates in this section to the capital gains, in excess of twenty-five thousand dollars ($25,000), determined under the Internal Revenue Code; or

(b) The tax determined by applying the rates in this section to the taxable income, in excess of twenty-five thousand dollars ($25,000);

In no event shall the tax levied by this subsection apply if Section 1374 of the Internal Revenue Code would exempt such capital gains from federal income tax.

Appendix E

TITLE XI. REVENUE AND TAXATION
CHAPTER 141. INCOME TAXES

KRS § 141.040 (Michie 1996)

§ 141.040. Corporation income tax -- Exemption -- Rate.

(1) Every corporation organized under the laws of this state, every corporation having its commercial domicile as defined in KRS 141.120(1)(b) in this state, and every foreign corporation owning or leasing property located in this state or having one (1) or more individuals receiving compensation as defined in KRS 141.120(8)(b) in this state, except those corporations listed in paragraphs (a) to (i) of this subsection, shall pay for each taxable year a tax to be computed by the taxpayer on taxable net income at the rates specified in subsections (2), (3), and (4) of this section:

(a) S corporations;

(b) Financial institutions, as defined in KRS 136.500, except bankers banks organized under KRS 287.135;

(c) Savings and loan associations organized under the laws of this state and under the laws of the United States and making loans to members only;

(d) Banks for cooperatives;

(e) Production credit associations;

(f) Insurance companies, including farmers or other mutual hail, cyclone, windstorm, or fire insurance companies, insurers, and reciprocal underwriters;

(g) Corporations exempt under Section 501 of the Internal Revenue Code;

(h) Religious, educational, charitable, or like corporations not organized or conducted for pecuniary profit; and

(i) Corporations having no individuals receiving compensation as defined in KRS 141.120(8)(b) in this state, and whose only owned or leased property located in this state is located at the premises of a printer with which it has contracted for printing, if such property consists of the final printed product, property which becomes a part of the final printed product, or copy from which the printed product is produced.

(2) For tax years ending before January 1, 1990, the following rates shall apply:

(a) Three percent (3%) of the first twenty-five thousand dollars ($25,000) of taxable net income;

(b) Four percent (4%) of the amount of taxable net income in excess of twenty-five thousand dollars ($25,000), but not in excess of fifty thousand dollars ($50,000);

(c) Five percent (5%) of the amount of taxable net income in excess of fifty thousand dollars ($50,000), but not in excess of one hundred thousand dollars ($100,000);

(d) Six percent (6%) of the amount of taxable net income in excess of one hundred thousand dollars ($100,000), but not in excess of two hundred fifty thousand dollars ($250,000); and

(e) Seven and twenty-five one hundredths percent (7.25%) of the amount of taxable net income in excess of two hundred fifty thousand dollars ($250,000).

(3) For tax years beginning after December 31, 1989, the following rates shall apply:

(a) Four percent (4%) of the first twenty-five thousand dollars ($25,000) of taxable net income;

(b) Five percent (5%) of the amount of taxable net income in excess of twenty-five thousand dollars ($25,000) but not in excess of fifty thousand dollars ($50,000);

(c) Six percent (6%) of the amount of taxable net income in excess of fifty thousand dollars ($50,000), but not in excess of one hundred thousand dollars ($100,000);

(d) Seven percent (7%) of the amount of taxable net income in excess of one hundred thousand dollars ($100,000), but not in excess of two hundred fifty thousand dollars ($250,000); and

(e) Eight and twenty-five one hundredths percent (8.25%) of the amount of taxable net income in excess of two hundred fifty thousand dollars ($250,000).

(4) For tax years beginning before January 1, 1990, and ending after December 31, 1989, the tax shall be the sum of the amounts determined in paragraphs (a) and (b) as follows:

(a) Apply the tax rates in subsection (2) of this section to the taxable net income for the year and multiply the result by a fraction, the numerator of which is the number of days from the first day of the taxable year through December 31, 1989, and the denominator of which is the total number of days of the taxable year; and

(b) Apply the tax rates in subsection (3) of this section to the taxable net income for

the year and multiply the result by a fraction, the numerator of which is the number of days from January 1, 1990, through the last day of the taxable year and the denominator of which is the total number of days of the taxable year.

(5) Every S corporation shall pay the tax imposed under subsection (1) of this section whenever the net capital gain of such corporation exceeds twenty-five thousand dollars ($25,000), and exceeds fifty percent (50%) of its taxable income for the taxable year and its taxable income for such year exceeds twenty-five thousand dollars ($25,000). The tax imposed by this subsection shall be the lower of:

(a) The tax determined by applying the rates in this section to the capital gains, in excess of twenty-five thousand dollars ($25,000), determined under the Internal Revenue Code; or

(b) The tax determined by applying the rates in this section to the taxable income, in excess of twenty-five thousand dollars ($25,000);

In no event shall the tax levied by this subsection apply if Section 1374 of the Internal Revenue Code would exempt such capital gains from federal income tax.

Appendix E

TITLE XI. REVENUE AND TAXATION
CHAPTER 141. INCOME TAXES

KRS § 141.235 (Michie 1993)

§ 141.235. Action interfering with collection or payment prohibited — Limitation on refund of taxes.

(1) No suit shall be maintained in any court to restrain or delay the collection or payment of the tax levied by this chapter.

(2) Any tax collected pursuant to the provisions of KRS Chapter 141, may be refunded or credited in the manner provided in KRS 134.580, provided that the claim for refund or credit is made within four (4) years of the due date of the return or the date the tax was paid, whichever is later, except that, in any case where the assessment period contained in KRS 141.210 has been extended by an agreement between the taxpayer and the cabinet, the limitation contained in this subsection shall be extended accordingly.

(3) Overpayments of taxes collected pursuant to KRS 141.300, 141.310, or 141.315 shall be refunded or credited with interest at the tax interest rate as defined in KRS 131.010(6). The interest shall not begin to accrue until ninety (90) days after the overpayment is made, the return was filed, or the due date of the return, whichever is later.

Appendix E

(4) Exclusive authority to refund or credit overpayments of taxes collected pursuant to this chapter is vested in the secretary or his authorized agent. Amounts directed to be refunded shall be paid out of the general fund.

Appendix E

TITLE XI. REVENUE AND TAXATION
CHAPTER 141. INCOME TAXES

KRS § 141.235 (Michie 1994)

§ 141.235. Action interfering with collection or payment prohibited — Limitation on refund of taxes.

(1) No suit shall be maintained in any court to restrain or delay the collection or payment of the tax levied by this chapter.

(2) Any tax collected pursuant to the provisions of this chapter may be refunded or credited in accordance with the provisions of KRS 134.580, provided that the claim for refund or credit is made within four (4) years of the last day prescribed by lawfor the filing of the return or the date the tax was paid, whichever is later, except that, except that;

> (a) In any case where the assessment period contained in KRS 141.210 has been extended by an agreement between the taxpayer and the cabinet, the limitation contained in this subsection shall be extended accordingly.
>
> (b) If the claim for refund or credit relates directly to adjustments resulting from a federal audit, the taxpayer shall file a claim for refund or credit within the time provided

for in this subsection or six (6) months from the conclusion of the federal audit, whichever is later.

(c) If the claim for refund or credit relates to an overpayment attributable to a net operating loss carryback or capital loss carryback, resulting from a loss which occurs in a taxable year beginning after December 31, 1993, the claim for refund or credit shall be filed within the times prescribed in this subsection for the taxable year of the net operating loss or capital loss which results in the carryback.

For the purposes of this subsection and subsection (3) of this section, a return filed before the last day prescribed by law for filing the return shall be considered as filed on the last day. For taxable years beginning after December 31, 1993, any extension of time granted for filing the return shall also be considered as extending the last day prescribed by law for filing the return.

(3) Overpayments of taxes collected pursuant to KRS 141.300, 141.310, or 141.315 shall be refunded or credited with interest at the tax interest rate as defined in KRS 131.010(6). The interest shall not begin to accrue until ninety (90) days after the tax was paid, the return was filed, or the last day prescribed by law for filing the return, whichever is later.

Appendix E

(4) Exclusive authority to refund or credit overpayments of taxes collected pursuant to this chapter is vested in the secretary or his authorized agent. Amounts directed to be refunded shall be paid out of the general fund.

Appendix E

TITLE XI. REVENUE AND TAXATION
CHAPTER 141. INCOME TAXES

KRS § 141.235 (Michie 1996)

§ 141.235. Action interfering with collection or payment prohibited — Limitation on refund of taxes.

(1) No suit shall be maintained in any court to restrain or delay the collection or payment of the tax levied by this chapter.

(2) Any tax collected pursuant to the provisions of this chapter may be refunded or credited in accordance with the provisions of KRS 134.580, except that:

> (a) In any case where the assessment period contained in KRS 141.210 has been extended by an agreement between the taxpayer and the cabinet, the limitation contained in this subsection shall be extended accordingly.
>
> (b) If the claim for refund or credit relates directly to adjustments resulting from a federal audit, the taxpayer shall file a claim for refund or credit within the time provided for in this subsection or six (6) months from the conclusion of the federal audit, whichever is later.

(c) If the claim for refund or credit relates to an overpayment attributable to a net operating loss carryback or capital loss carryback, resulting from a loss which occurs in a taxable year beginning after December 31, 1993, the claim for refund or credit shall be filed within the times prescribed in this subsection for the taxable year of the net operating loss or capital loss which results in the carryback.

For the purposes of this subsection and subsection (3) of this section, a return filed before the last day prescribed by law for filing the return shall be considered as filed on the last day.

(3) Overpayments of taxes collected pursuant to KRS 141.300, 141.310, or 141.315 shall be refunded or credited with interest at the tax interest rate as defined in KRS 131.010(6). The interest shall not begin to accrue until ninety (90) days after the tax was paid, the return was filed, or the last day prescribed by law for filing the return, whichever is later.

(4) Exclusive authority to refund or credit overpayments of taxes collected pursuant to this chapter is vested in the secretary or his authorized agent. Amounts directed to be refunded shall be paid out of the general fund.

APPENDIX F — BALDWIN'S CERTIFIED VERSION KRS KENTUCKY REVISED STATUTES AND RULES SERVICE, 2008 ACTS ISSUE

Acts of the 2008 Regular and First Extraordinary Session of the General Assembly with Official KRS Numbers Designated by the Reviser of Statutes

TAXATION—FINES AND PENALTIES
SCHOOLS AND SCHOOL DISTRICTS

CHAPTER 132

HB 704

AN ACT relating to fiscal matters and declaring an emergency. *Be it enacted by the General Assembly of the Commonwealth of Kentucky.*

* * *

Section 8. KRS 131.183 is amended to read as follows:

131.183

(1) *(a)* All taxes payable to the Commonwealth not paid at the time prescribed by statute shall accrued interest at the tax interest rate. ~~The tax interest rate for tax liabilities that are assessed on or after July 1, 1982, shall be sixteen percent (16%). This tax interest rate shall apply until January 1, 1983, when the tax interest rate shall be adjusted as provided in this section. The commissioner of revenue shall adjust the tax interest rate not later than November 15 of any year,~~

~~beginning in 1982, if the adjusted prime rate charged by banks during October of that year, rounded to the nearest full percent, is at least one(1) percentage point more or less than the tax interest rate which is then in effect.~~

(b) The tax interest rate shall be equal to the adjusted prime rate charged by banks rounded to the nearest full percent *as adjusted by subsection (2) of this section.*

(c) The commissioner of revenue shall adjust the tax interest rate not later than November 15 of each year if the adjusted prime rate charged by banks during October of that year, rounded to the nearest full percent, is at least one (1) percentage point more of less than the tax interest rate which is then in effect. The adjusted tax interest rate, ~~and~~ shall become effective on January 1 of the immediately succeeding year.

(2) *(a) 1. All taxes payable to the Commonwealth that have not been paid at the time prescribed by statute shall accrue interest at the tax interest rate as determined in accordance with subsection (1) of this section until May 1, 2008.*

2. Beginning on May 1, 2008, all taxes payable to the Commonwealth that have not been paid at the time prescribed by statute shall accrue interest at the tax interest rate as determined in accordance with subsection (1) of this section plus two percent (2%).

(b) 1. Interest shall be allowed and paid upon any overpayment *as defined in KRS 134.580* in respect of any of the taxes provided for in Chapters 131, 132, 134, 136, 137, 138, 139, 140, 141, 142, 143, 143A, and 243 of the Kentucky Revised Statutes and KRS 160.613 and 160.614 at the rate provided in subsection (1) *of this section until May 1, 2008*~~above~~.

2. Beginning on May 1, 2008, interest shall be allowed and paid upon any overpayment as defined in KRS 134.580 at the rate provided in subsection (1) of this section minus two percent (2%).

3. Effective for refunds issued after the effective date of this Act, except for the provisions of KRS 138.351, 141.044(2), 141.235(3), and subsection (3) of this section, interest authorized under this subsection shall begin to accrue sixty (60) days after *the latest of:*

a. The due date of the return;
b. The date the return was filed; ~~or~~
c. The date the tax was paid;
d. The last day prescribed by law for filing the return; or
e. The date an amended return claiming a refund is filed.;
~~whichever is later, and~~

(c) In no case shall interest be paid in an amount less than five dollars ($5).

(3) Effective for refund claims filed on or after July 15, 1992, if any overpayment of the tax imposed under KRS Chapter 141 results from a carryback of a net operating loss or a net capital loss, the overpayment shall be deemed to have been made on the date the claim for refund was filed. Interest authorized under subsection (2) of this section shall begin to accrue ninety (90) days from the date the claim for refund was filed.

(4) No interest shall be allowed or paid on any sales tax refund as provided by KRS 139.536.

* * *

Section 10. KRS 141.235 is amended to read as follows:

141.235

(1) No suit shall be maintained in any court to restrain or delay the collection or payment of the tax levied by this chapter.

(2) Any tax collected pursuant to the provisions of this chapter may be refunded or credited in accordance with the provisions of KRS 134.580, except that:

(a) In any case where the assessment period contained in KRS 141.210 has been extended by an agreement between the taxpayer and the department, the limitation contained in this subsection shall be extended accordingly.

(b) If the claim for refund or credit relates directly to adjustments resulting from a federal audit, the taxpayer shall file a claim for refund or credit within the time provided for in this subsection or six (6) months from the conclusion of the federal audit, whichever is later.

(c) If the claim for refund or credit relates to an overpayment attributable to a net operating loss carryback or capital loss carryback, resulting from a loss which occurs in a taxable year beginning after December 31, 1993, the claim for refund or credit shall be filed within the times prescribed in this subsection for the taxable year of the net operating loss or capital loss which results in the carryback.

For the purposes of this subsection and subsection (3) of this section, a return filed before the last day prescribed by law for filing the return shall be considered as filed on the last day.

(3) Overpayments *as defined in KRS 134.580* of taxes collected pursuant to KRS 141.300, 141.310, or 141.315 shall be refunded or credited with interest at the tax interest rate as defined in KRS 131.010(6). *Effective for refunds issued after the effective date of this Act,* the interest shall not begin to accrue until ninety (90) days after the *latest of:*

(a) The due date of the return;

(b) The date the return was filed;

(c) The date the tax was filed;

(d) ~~The return was filed, or the~~ last day prescribed by law for filing the return; *or*

(e) The date an amended return *claiming a refund is filed*~~, whichever is later~~.

(4) Exclusive authority to refund or credit overpayments of taxes collected pursuant to this chapter is vested in the commissioner or his authorized agent. Amounts directed to be refunded shall be paid out of the general fund.

* * *

Section 11. KRS 134.580 is amended to read as follows:

134.580

(1) As used in this section, unless the context requires otherwise:

(a) "Agency" means the agency of state government which administers the tax to be refunded or credited.

(b) "Overpayment" or "payment where no tax was due" means the *excess of the tax payments made over the correct* tax liability *determined* under the terms of the applicable statute without reference to the constitutionality of the statute.

(2) When money has been paid into the State Treasury in payment of any state taxes, except ad valorem taxes, whether payment was made voluntarily or involuntarily, the appropriate agency shall authorize refunds to the person who paid the tax, or to his heirs, personal representatives or assigns, of any overpayment of tax and any payment where no tax was due. When a bona fide controversy exists between the agency and the taxpayer as to the liability of the taxpayer for the payment of tax claimed to be due by the agency, the taxpayer may pay the amount claimed by the agency to be due, and if an appeal is taken by the taxpayer from the ruling of the agency within the time provided by KRS 131.340 and it is finally adjudged that the taxpayer was not liable for the payment of the tax or any part thereof, the agency shall authorize the refund or credit as the Kentucky Board of Tax Appeals or courts may direct.

(3) No refund shall be made unless each taxpayer individually files an application or claim for the refund within four (4) years from the date payment was made. Each claim or application for a refund shall be in writing and state the specific grounds upon which it is based. Denials of refund claims or applications may be protested and appealed in accordance with KRS 131.110 and 131.340.

(4) Refunds shall be authorized with interest as provided in KRS 131.183. The refunds authorized by this section shall be made in the same manner as other claims on the State Treasury are paid. They shall not be charged

against any appropriation, but shall be deducted from tax receipts for the current fiscal year.

(5) Nothing in this section shall be construed to authorize the agency to make or cause to be made any refund except within four (4) years of the date prescribed by law for filing of a return including any extension of time for the filing the return, or the date the money was paid into the State Treasury, whichever is the later, except in any case where the assessment period has been extended by written agreement between the taxpayer and the department, the limitation contained in this subsection shall be extended accordingly. Nothing in this section shall be construed as requiring the agency to authorize any refund to a taxpayer without demand from the taxpayer, if in the opinion of the agency the cost to the state of authorizing the refund would be greater than the amount that should be refunded or credited.

(6) This section shall not apply to any case in which the statute may be held unconstitutional, either in whole or in part.

(7) In cases in which a statute has been held unconstitutional, taxes paid thereunder may be refunded to the extent provided by KRS 134.590, and by the statute held unconstitutional.

(8) No person shall secure a refund of motor fuels tax under KRS 134.580 unless the person holds an unrevoked refund permit issued by the department before the purchase of gasoline or special fuels and that

permit entitles the person to apply for a refund under KRS 138.344 to 138.355.

(9) Notwithstanding any provision of the Kentucky Revised Statutes to the contrary:

(a) The Commonwealth hereby revokes and withdraws its consent to suit in any forum whatsoever on any claim for recovery, refund, or credit of any tax overpayment for any taxable year ending before December 31, 1995, made by an amended return or any other method after December 22, 1994, and based on a change from any initially filed separate return or returns to a combined return under the unitary business concept or to a consolidated return. No such claim shall be effective or recognized for any purpose.

(b) Any stated or implied consent for the Commonwealth of Kentucky, or any agent or officer of the Commonwealth of Kentucky, to be sued by any person for any legal, equitable, or other relief with respect to any claim for recovery, refund, or credit of any tax overpayment for any taxable year ending before December 31, 1995, made by an amended return or any other method after December 22, 1994, and based on a change from any initially filed separate return or returns to a combined return under the unitary business concept or to a consolidated return, is hereby withdrawn.

(c) The provisions of this subsection shall apply retroactively for all taxable years ending before December 31, 1995, and shall apply to all claims for such

taxable years pending in any judicial or administrative forum.

(10) Notwithstanding any provision of the Kentucky Revised Statutes to the contrary:

(a) No money shall be drawn from the State Treasury for the payment of any claim for recovery, refund, or credit of any tax overpayment for any taxable year ending before December 31, 1995, made by an amended return or any other method after December 22, 1994, and based on a change from any initially filed separate return or returns to a combined return under the unitary business concept or to a consolidated return.

(b) No provision of the Kentucky Revised Statutes shall constitute an appropriation or mandated appropriation for the payment of any claim for recovery, refund, or credit of any tax overpayment for any taxable year ending before December 31, 1995, made by an amended return or any other method after December 22, 1994, and based on a change from any initially filed separate return or returns to a combined return under the unitary business concept or to a consolidated return.

* * *

Section 15. The provisions of Sections 8 to 11 of this Act shall apply retroactively to all outstanding refund claims for taxable years ending prior to the effective date of this Act and shall apply to all claims for those taxable years pending in any judicial or administrative forum.

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* * *

Section 17. Whereas it is necessary to expediently address issues originally addressed in 2006 Ky. Acts ch. 252, an emergency is declared to exist, and Sections 1 to 6 and 8 to 15 of this Act takes effect upon its passage and approval by the Governor or upon its otherwise becoming a law.

* * *

Approved April 24, 2008.

Appendix F

COMMONWEALTH OF KENTUCKY
STATE FISCAL NOTE STATEMENT

GENERAL ASSEMBLY
2008 REGULAR SESSION

LEGISLATIVE RESEARCH COMMISSION
2008-2010 INTERIM

MEASURE

(x) 2008 BR No. 1831 (x) House Bill No. 704 GA

( ) Resolution No. _____ ( ) Amendment No. _____

SUBJECT/TITLE AN ACT relating to revenue and taxation.

SPONSOR Rep. H. Moberly

NOTE SUMMARY

Fiscal Analysis: ___ Impact X No Impact ___ Indeterminable Impact

Level(s) of Impact: ___ State ___ Local ___ Federal

Budget Unit(s) Impact _____

Fund(s) Impact: X General ___ Road ___ Federal

_____ Restricted Agency (Type) _____ (Other)

FISCAL SUMMARY

Fiscal Estimates	2007-2008	2008-2009	2009-2010	Future Annual Rate of Change
Revenues (+/-)				
Expenditures (+/-)				
Net Effect			No Impact	No Impact

MEASURE'S PURPOSE:

This bill is the Department of Revenue's housekeeping legislation. It contains several changes that bring statutes into alignment with federal law, judicial action, and technology changes. Three additional components were added by amendment and are included in the GA version; First, the earmarking of one penny of the cigarette tax for cancer research. This has been directed in the budget bill for several years; this change codifies that earmark as permanent law. Second, the motor fuels tax will increase under operation of current statute by 1.5 cents on July 1, 2008. The amount of that increase that is retained at the state level and not available for local government revenue sharing is limited by this bill. The amount that is retained at the state level is 1.4 cents, leaving 0.1 cent to be revenue shared with local governments. The third change clarifies that importers of cigarettes are required to file the same monthly reports that are filed by manufacturers of cigarettes.

PROVISION/MECHANICS:

Amend KRS 136.392 to codify several court decisions; amend KRS 138.195 to clarify that manufacturersand first importers are to submit to the department monthly reports of all shipments of cigarettes, other tobacco products, or snuff to persons within this state; amend KRS 141.160 to clarify that income tax returns of cooperatives are to be made on September 15 in each year, unless the return is prepared on a fiscal year basis; amend KRS 160.6156 to provide that a utility service provider shall not be entitled to a refund or credit of taxes paid, unless the provider refunds or credits its related customers the amount of overpayment made to the department; amend KRS 160.6157 to allow the department to issue a penalty on a utility service provider who erroneously bills a customer after being notified by the department of the error in an amount equal to $25 per subsequent error, not to exceed $10,000 per month; amend KRS 160.6158 to allow the penalty to be waived based on reasonable cause. KRS 138.140 is

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amended to codify the earmark for cancer research, and KRS 138.220 is amended to specify the amount of the motor fuels tax that would not be revenue shared.

FISCAL EXPLANATION:

There is no expected fiscal impact from this bill. The changes represent current practice based on federal and judicial guidelines, and to align with currently available technology. The amendments included in the GA version also contain no expected fiscal impact. The cigarette tax earmark has been done for several years through budget bill language, and the motor fuels tax does not increase or decrease because of this language change.

DATA SOURCE(S) Dept. of Revenue, OSBD, LRC staff.

NOTE NO. 131.1 PREPARER John Scott REVIEW LBH DATE 03-14-08

APPENDIX G — BALDWIN'S CERTIFIED VERSION KRS KENTUCKY REVISED STATUTES AND RULES SERVICE, 2009 ACTS ISSUE

Acts of the 2009 Regular Session of the General Assembly with Official KRS Numbers Designated by the Reviser of Statutes

* * *

TAXATION—CHARITABLE AUCTION

CHAPTER 86

HB 216

AN ACT relating to fiscal matter and declaring an emergency. *Be it enacted by the General Assembly of the Commonwealth of Kentucky.*

* * *

Section 7. KRS 131.183 is repealed and reenacted to read as follows:

131.183

(1) (a) All taxes payable to the Commonwealth not paid at the time prescribed by statute shall accrue interest at the tax interest rate.

(b) The tax interest rate shall be equal to the adjusted prime rate charged by banks rounded to the nearest full percent as adjusted by subsection (2) of this section.

(c) The commissioner of revenue shall adjust the tax interest rate not later than November 15 of each year if the adjusted prime rate charged by banks during October of that year, rounded to the nearest full percent, is at least one (1) percentage point more of less than the tax interest rate which is then in effect. The adjusted tax interest rate shall become effective on January 1 of the immediately succeeding year.

(2) (a) 1. All taxes payable to the Commonwealth that have not been paid at the time prescribed by statute shall accrue interest at the tax interest rate as determined in accordance with subsection (1) of this section until May 1, 2008.

2. Beginning on May 1, 2008, all taxes payable to the Commonwealth that have not been paid at the time prescribed by statute shall accrue interest at the tax interest rate as determined in accordance with subsection (1) of this section plus two percent (2%).

(b) 1. Interest shall be allowed and paid upon any overpayment as defined in KRS 134.580 in respect of any of the taxes provided for in Chapters 131, 132, 134, 136, 137, 138, 139, 140, 141, 142, 143, 143A, and 243 of the Kentucky Revised Statutes and KRS 160.613 and 160.614 at the rate provided in subsection (1) of this section until May 1, 2008.

2. Beginning on May 1, 2008, interest shall be allowed and paid upon any overpayment as defined in KRS 134.580 at the rate provided in subsection (1) of this section minus two percent (2%).

3. Effective for refunds issued after April 24, 2008, except for the provisions of KRS 138.351, 141.044(2), 141.235(3), and subsection (3) of this section, interest authorized under this subsection shall begin to accrue sixty (60) days after the latest of:

a. The due date of the return;
b. The date the return was filed;
c. The date the tax was paid;
d. The last day prescribed by law for filing the return; or
e. The date an amended return claiming a refund is filed.

(c) In no case shall interest be paid in an amount less than five dollars ($5).

(3) Effective for refund claims filed on or after July 15, 1992, if any overpayment of the tax imposed under KRS Chapter 141 results from a carryback of a net operating loss or a net capital loss, the overpayment shall be deemed to have been made on the date the claim for refund was filed. Interest authorized under subsection (2) of this section shall begin to accrue ninety (90) days from the date the claim for refund was filed.

(4) No interest shall be allowed or paid on any sales tax refund as provided by KRS 139.536.

* * *

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Section 9. KRS 141.235 is repealed and reenacted to read as follows:

141.235

(1) No suit shall be maintained in any court to restrain or delay the collection or payment of the tax levied by this chapter.

(2) Any tax collected pursuant to the provisions of this chapter may be refunded or credited in accordance with the provisions of KRS 134.580, except that:

(a) In any case where the assessment period contained in KRS 141.210 has been extended by an agreement between the taxpayer and the department, the limitation contained in this subsection shall be extended accordingly.

(b) If the claim for refund or credit relates directly to adjustments resulting from a federal audit, the taxpayer shall file a claim for refund or credit within the time provided for in this subsection or six (6) months from the conclusion of the federal audit, whichever is later.

(c) If the claim for refund or credit relates to an overpayment attributable to a net operating loss carryback or capital loss carryback, resulting from a loss which occurs in a taxable year beginning after December 31, 1993, the claim for refund or credit shall be filed

within the times prescribed in this subsection for the taxable year of the net operating loss or capital loss which results in the carryback.

For the purposes of this subsection and subsection (3) of this section, a return filed before the last day prescribed by law for filing the return shall be considered as filed on the last day.

(3) Overpayments as defined in KRS 134.580 of taxes collected pursuant to KRS 141.300, 141.310, or 141.315 shall be refunded or credited with interest at the tax interest rate as defined in KRS 131.010(6). Effective for refunds issued after April 24, 2008, the interest shall not begin to accrue until ninety (90) days after the latest of:

(a) The due date of the return;
(b) The date the return was filed;
(c) The date the tax was paid;
(d) The last day prescribed by law for filing the return; or
(e) The date an amended return claiming a refund is filed.

(4) Exclusive authority to refund or credit overpayments of taxes collected pursuant to this chapter is vested in the commissioner or his authorized agent. Amounts directed to be refunded shall be paid out of the general fund.

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Section 10. KRS 134.580 is repealed and reenacted to read as follows:

134.580

(1) As used in this section, unless the context requires otherwise:

(a) "Agency" means the agency of state government which administers the tax to be refunded or credited.

(b) "Overpayment" or "payment where no tax was due" means the excess of the tax payments made over the correct tax liability determined under the terms of the applicable statute without reference to the constitutionality of the statute.

(2) When money has been paid into the State Treasury in payment of any state taxes, except ad valorem taxes, whether payment was made voluntarily or involuntarily, the appropriate agency shall authorize refunds to the person who paid the tax, or to his heirs, personal representatives or assigns, of any overpayment of tax and any payment where no tax was due. When a bona fide controversy exists between the agency and the taxpayer as to the liability of the taxpayer for the payment of tax claimed to be due by the agency, the taxpayer may pay the amount claimed by the agency to be due, and if an appeal is taken by the taxpayer from the ruling of the agency within the time provided by KRS 131.340 and it is finally adjudged that the taxpayer

was not liable for the payment of the tax or any part thereof, the agency shall authorize the refund or credit as the Kentucky Board of Tax Appeals or courts may direct.

(3) No refund shall be made unless each taxpayer individually files an application or claim for the refund within four (4) years from the date payment was made. Each claim or application for a refund shall be in writing and state the specific grounds upon which it is based. Denials of refund claims or applications may be protested and appealed in accordance with KRS 131.110 and 131.340.

(4) Refunds shall be authorized with interest as provided in KRS 131.183. The refunds authorized by this section shall be made in the same manner as other claims on the State Treasury are paid. They shall not be charged against any appropriation, but shall be deducted from tax receipts for the current fiscal year.

(5) Nothing in this section shall be construed to authorize the agency to make or cause to be made any refund except within four (4) years of the date prescribed by law for the filing of a return including any extension of time for filing the return, or the date the money was paid into the State Treasury, whichever is the later, except in any case where the assessment period has been extended by written agreement between the taxpayer and the department, the limitation contained in this subsection shall be extended accordingly. Nothing in this section shall be construed as requiring the agency to

authorize any refund to a taxpayer without demand from taxpayer, if in the opinion of the agency the cost to the state of authorizing the refund would be greater than the amount that should be refunded or credited.

(6) This section shall not apply to any case in which the statute may be held unconstitutional, either in whole or in part.

(7) In cases in which a statute has been held unconstitutional, taxes paid thereunder may be refunded to the extent provided by KRS 134.590, and by the statute held unconstitutional.

(8) No person shall secure a refund of motor fuels tax under KRS 134.580 unless the person holds an unrevoked refund permit issued by the department before the purchase of gasoline or special fuels and that permit entitles the person to apply for a refund under KRS 138.344 to 138.355.

(9) Notwithstanding any provision of the Kentucky Revised Statutes to the contrary:

(a) The Commonwealth hereby revokes and withdraws its consent to suit in any forum whatsoever on any claim for recovery, refund, or credit of any tax overpayment for any taxable year ending before December 31, 1995, made by an amended return or any other method after December 22, 1994, and based on a change from any initially filed separate return or returns to a combined return under the unitary business concept

or to a consolidated return. No such claim shall be effective or recognized for any purpose.

(b) Any stated or implied consent for the Commonwealth of Kentucky, or any agent or officer of the Commonwealth of Kentucky, to be sued by any person for any legal, equitable, or other relief with respect to any claim for recovery, refund, or credit of any tax overpayment for any taxable year ending before December 31, 1995, made by an amended return or any other method after December 22, 1994, and based on a change from any initially filed separate return or returns to a combined return under the unitary business concept or to a consolidated return, is hereby withdrawn.

(c) The provisions of this subsection shall apply retroactively for all taxable years ending before December 31, 1995, and shall apply to all claims for such taxable years pending in any judicial or administrative forum.

(10) Notwithstanding any provision of the Kentucky Revised Statutes to the contrary:

(a) No money shall be drawn from the State Treasury for the payment of any claim for recovery, refund, or credit of any tax overpayment for any taxable year ending before December 31, 1995, made by an amended return or any other method after December 22, 1994, and based on a change from any initially filed separate return or returns to a combined return under the unitary business concept or to a consolidated return.

(b) No provision of the Kentucky Revised Statutes shall constitute an appropriation or mandated appropriation for the payment of any claim for recovery, refund, or credit of any tax overpayment for any taxable year ending before December 31, 1995, made by an amended return or any other method after December 22, 1994, and based on a change from any initially filed separate return or returns to a combined return under the unitary business concept or to a consolidated return.

* * *

Section 15. The provisions of Sections 7 to 10 of this Act shall apply retroactively to all outstanding refund claims for taxable years ending prior to the effective date of this Act and shall apply to all claims for those taxable years pending in any judicial or administrative forum.

* * *

Section 17. The intent of the General Assembly in repealing and reenacting KRS 136.392, 138.195, 141.160, 160.6156, 160.6157, 160.6158, 131.183, 141.044, 141.235, 134.580, 393.060, and 157.621 in Sections 1 to 12 of this Act is to affirm the amendments made to these sections in 2008 Ky. Acts ch. 132. The provisions in Sections 1 to 12 of this Act shall apply retroactively to April 24, 2008.

Section 18. To the extent that any provision included in this act is considered new language, the provisions of KRS 446.145 requiring such new language to be underlined are notwithstood.

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Section 19. Whereas it is necessary to expediently address issues originally addressed in 2006 Ky. Acts ch. 252, an emergency is declared to exist, and Sections 1 to 12 of this Act take effect upon the Act's passage and approval by the Governor or upon its otherwise becoming a law.

* * *

Approved March 24, 2009.

Appendix G

COMMONWEALTH OF KENTUCKY
STATE FISCAL NOTE STATEMENT

GENERAL ASSEMBLY
2009 REGULAR SESSION

LEGISLATIVE RESEARCH COMMISSION
2008-2010 INTERIM

MEASURE

(x) 2009 BR No. 0333 (x) House Bill No. 216 GA

( ) Resolution No. _____ ( ) Amendment No. _____

SUBJECT/TITLE AN ACT relating to fiscal matters and declaring an emergency.

SPONSOR Rep. Rick Rand

NOTE SUMMARY

Fiscal Analysis: ___ Impact _x_ No Impact ___ Indeterminable Impact

Level(s) of Impact: _x_ State ___ Local ___ Federal

Budget Unit(s) Impact _____

Fund(s) Impact: ___ General ___ Road ___ Federal

_____ Restricted Agency (Type) _____ (Other)

FISCAL SUMMARY

Fiscal Estimates	2008-2009	2009-2010	2010-2011	Future Annual Rate of Change
Revenues (+/-)	-0-	-0-	-0-	-0-
Expenditures (+/-)				
Net Effect	-0-	-0-	-0-	-0-

MEASURE'S PURPOSE:
The bill repeals and reenacts various statutes that were passed by the 08 Regular Session of the General Assembly.

PROVISION/MECHANICS:
The bill repeals and reenacts various statutes that were passed by the 08 Regular Session of the General Assembly.

FISCAL EXPLANATION:
There is no fiscal impact from this bill.

DATA SOURCE(S) LRC Staff

NOTE NO. 27.1 PREPARER John Scott REVIEW LBH DATE 3/10/09

LRC 2009-0333-HB216-GA

APPENDIX H — EXPERT OPINION OF PROFESSOR RICHARD D. POMP

Introduction

You have contacted me as the former Director of the New York Tax Study Commission and as someone who for nearly 25 years has studied, lectured, taught, published, and consulted with, and testified on behalf of, state governments, regarding issues of state taxation.

You have asked my opinion about the policies that distinguish due process nexus from commerce clause nexus. In addition, you have asked whether physical presence or metaphysical presence is more compatible with the values underlying the commerce clause. Specifically, you have asked my opinion on whether physical presence or metaphysical presence is more consistent with sound tax policy.

Your questions arise from a case involving an out-of-state corporation having no property or payroll in Kentucky, which is a partner in a Kentucky partnership. The Kentucky partnership has nexus with Kentucky under the Kentucky corporation income tax. Should the out-of-state corporation be viewed as a shareholder in a corporation, in which case the shareholder would not be viewed as having nexus with Kentucky. The Revenue Cabinet, however, apparently rejects this view.

The Revenue Cabinet requires corporate partners to include in apportionable income their distributive share of partnership business income and considers this

income to be from intangible property. The Revenue Cabinet does not take a similar position with respect to shareholders receiving dividends from corporations doing business in Kentucky. The Revenue Cabinet does not treat the factors of the partnership as flowing through to the partners.

Due Process Nexus and Commerce Clause Nexus: A Policy Overview

As background for understanding the policy considerations that are relevant in analyzing the position of the Revenue Cabinet, you have asked me the policy differences between due process nexus and commerce clause nexus. Due process nexus is concerned with the fundamental fairness of governmental activity. It requires a state to ask whether a person's connections with it are substantial enough to legitimate the state's exercise of power over that person. "Notice" or "fair warning" is the analytic touchstones of due process nexus.

In contrast, commerce clause nexus is informed by structural concerns about the effects of state taxation on the national economy. A state must ask whether its actions hinder, suppress, or unduly burden interstate commerce. Commerce clause nexus is a means for limiting state burdens on interstate commerce.

As this brief description suggests, due process nexus is a very different concept from commerce clause nexus and a person that has due process nexus with a state

does not necessarily have commerce clause nexus. The Revenue Cabinet's position regarding the taxation of an out-of-state corporate partner having no property or payroll in Kentucky raises questions concerning both types of nexus, but my opinion is limited to only the policy considerations surrounding commerce clause nexus.

There is no doubt that commerce clause nexus can be satisfied by a person's physical presence. This physical presence standard has the blessing of the U.S. Supreme Court and that of all state courts. As the name implies, physical presence or physical nexus refers to the presence in a state of tangible property or of personnel of the taxpayer. Physical nexus has a long history and tradition and provides a standard that in nearly all cases is unambiguous and easily applied. Moreover, physical presence provides a determinate solution to the issue of nexus because property or persons cannot simultaneously exist in more than one state. An out-of-state corporation that does not have any payroll or payroll in Kentucky does not have any physical presence in Kentucky.

The out-of-state corporate partner that the Revenue Cabinet seeks to tax does not have any physical presence of its own in Kentucky, and I do not believe the Revenue Cabinet is challenging that proposition. Instead, the Revenue Cabinet seems to be applying a new standard of commerce clause nexus: metaphysical nexus. The partner is physically present in Kentucky because of its interest in a partnership that is doing business in Kentucky. An interest in a partnership is intangible or metaphysical property.

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Metaphysical nexus is an incorporeal standard, which does not require that a taxpayer have any physical presence in a state. Rather, a corporation is present under this theory because of various legal relationships that exist between itself and some other person that is present in the Kentucky. In the present case, the Revenue Cabinet's position seems to be that the out-of-state corporation is present in Kentucky because of its intangible interest in a partnership that is doing business in Kentucky.

A Policy Evaluation of Physical and Metaphysical Presence

You have asked me to evaluate from a policy perspective the merits of physical presence nexus versus metaphysical presence nexus. Various criteria exist for evaluating the relative merits of these competing nexus standards in the context of the values and goals that underlie the commerce clause. The criteria that are evaluated below ask which nexus standard is: (1) more consistent with a bright line test; (2) more consistent with settled expectations; (3) more likely to reduce litigation and foster interstate investment; (4) less likely to discriminate against the service sector; (5) less likely to lead to multiple taxation; and (6) more likely to be fairly or easily administered.

For the reasons explained below, I conclude that physical presence is clearly superior to metaphysical presence as a nexus standard when measured against any of these relevant, principled criteria. Further, I conclude that the

nexus standard for income taxes should be the same as the nexus standard for sales and use taxes.

1. Physical presence is more consistent with a bright line test

The U.S. Supreme Court has emphasized the need for a bright line rule for commerce clause nexus. The reason for a bright line rule is that a nexus standard operates in a stark, all or nothing fashion: a company will be subject to either an income tax or it will not. The need for a bright line test is especially acute where millions of dollars of income taxes can turn on whether nexus exists.

From this policy perspective, an overwhelming virtue of the physical presence standard is that it provides a bright line test. People or tangible property are visible and can be identified through physical observation. Their existence and presence is unambiguous; people or property are either in a state or they are not.

In sharp contrast, metaphysical presence is an amorphous concept, having no crisp edges. The essence of intangible property, such as a partnership interest, a share of stock, or a license agreement, is that it cannot be perceived or physically located. As the dictionary recognizes, intangible property "cannot be easily defined, formulated, or grasped."[1]

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1. Webster's New Universal Unabridged Dictionary (Deluxe 2nd ed.).

Appendix H

Unlike persons or tangible property that can be identified geographically, intangible property cannot be located in any particular state except through legal fictions or doctrines. Various legal fictions include the doctrine of mobilia sequuntur personam, which treats intangibles as attached to the person that owns them. Another legal fiction locates an intangible at the payor's residence, that is, at the residence of the person that pays income to those holding the intangible interest. Yet another approach creates the fiction that an intangible has a business situs.

The problem that arises with these legal fictions is that they do not produce a unique solution to where an intangible is located. For example, the doctrine of mobilia sequuntur personam, when applied to a corporation, can assign intangibles to either the legal domicile of a corporation or its commercial domicile. Further, even the common rule that provides that certain types of intangibles, such as copyrights and patents, are located in the place in which the property is used, does not necessarily locate the intangible unambiguously in only one state. Consider, for example, a manufacturer that enters into a license agreement allowing it to use a secret process to produce and sell widgets. One state might locate the license agreement in the state of manufacturing whereas another might locate it in the state of sale.

Intangible property is not capable of being observed and physically located in one unique state. By contrast, no one can dispute the location of a person or of tangible

property. Compared with a physical presence standard, metaphysical presence not only provides no bright line rule, but also provides no determinate or unique answer to the nexus question. A rule that can locate an intangible simultaneously in more than one state is not a principle of nexus but rather an invitation to chaos.

2. Physical presence is more consistent with settled expectations

There is no U.S. Supreme Court case holding that metaphysical presence satisfies commerce clause nexus. All of the U.S. Supreme Court cases dealing with commerce clause nexus for corporate income tax purposes involved corporations that had a physical presence. None involved an out-of-state corporate partner. Indeed, taxpayers have been very careful in structuring their activities to avoid having a physical presence in those states in which they did not wish to have nexus. In my opinion, the expectation of corporate taxpayers is that no nexus exists under the commerce clause without physical presence.

The metaphysical presence rule is obviously inconsistent with this expectation. If this expectation is to be frustrated by the imposition of a new, metaphysical presence rule, Congress is the only appropriate body to do so. Corporations relying on the physical presence standard have not filed income tax returns on the justifiable assumption that nexus did not exist. Without the filing of a return, the statute of limitations does not run in most states and localities. Consequently,

enormous retroactive exposure exists if a new nexus standard is adopted by a jurisdiction. Congress is the ideal body to balance the interests of the various parties should it decide that the commerce clause nexus standard should be changed.

3. Physical presence will reduce litigation and foster interstate investment

The physical presence nexus standard has the weight of history and tradition behind it. It has been litigated over the years and its boundaries are well known and accepted. It provides a knowable and determinable standard. Long-standing precedent supports the standard, which furthers the stability and orderly development of the law. A long-standing doctrine like that of physical presence offers the kind of stability and predictability that fosters interstate investment.

Metaphysical nexus, by the very nature of intangible property, invites years of litigation. The very fact that intangible property does not physically exist in the way that tangible property or persons exist is an invitation to endless litigation and chaos. Metaphysical presence cannot be expected to have the same crisp, sharp edges as a concept as does physical presence, even after years of litigation. The uncertainty and cloud over the concept of metaphysical nexus can only discourage certain types of interstate investment and thereby thwart the goals of the commerce clause.

4. Metaphysical presence discriminates against the service sector

The physical presence nexus standard has helped maintain tax parity between the service sector and the manufacturing and mercantile sectors of the economy. The manufacturing and mercantile sectors have been the beneficiaries of a special federal nexus statute, Public Law 86-272. The physical presence nexus standard complements Public Law 86-272 in a very significant way that helps maintain a level playing field between the manufacturing and mercantile sectors and the service sector.

Specifically, Public Law 86-272 provides a federal nexus standard by preventing a state from taxing the income of a corporation whose only business activities within the state consist of the solicitation of orders for *tangible personal property*. Public Law 86-272 is limited to tangible personal property and does not extend to services. This limitation is presumably explained by two factors. First, the law was enacted in order to overrule *Northwestern Portland Cement*,[2] which upheld the imposition of a tax on the income of a purely interstate taxpayer selling tangible property--not services.

Second, the law was adopted in 1959, at a time when the service sector was greatly overshadowed by the manufacturing and mercantile sectors. Further, the service sector tended to be intrastate in nature and not

2. 358 U.S. 450 (1959).

interstate. Accordingly, when Public Law 86-272 was adopted, Congress was focusing on the sale of tangible personal property and not on the relatively insignificant interstate service sector.

As interstate services grew in importance and significance, the physical presence rule allowed the service sector to achieve similar protection to that extended to the manufacturing and mercantile sectors under Public Law 86-272. Physical presence nexus is to the service sector what Public Law 86-272 is to the manufacturing and mercantile sectors.

The understanding and expectation of interstate service providers is that as long as they solicit in a state without having people or property in that state, no commerce clause nexus exists and no income tax can be imposed. The requirement of physical presence thus allows the service sector to achieve nearly the same treatment as those taxpayers that are protected by Public Law 86-272. Accordingly, the physical presence standard helps maintain competitive equity between taxpayers that provide services and those competitors that provide tangible personal property.

A metaphysical presence rule would upset this balance and accommodation. Metaphysical nexus would exaggerate, rather than reduce, the competitive inequities of Public Law 86-272. The result would be to move away from a level playing field and discriminate against service providers, thus interfering unfairly and inequitably with the most rapidly growing sector in the U.S. economy.

Appendix H

5. Metaphysical presence will lead to multiple taxation

As discussed above, intangible property has no corporeal form and does not physically exist. Consequently, unlike people or tangible property, intangible property cannot be physically located in any particular state through physical observation. Intangible property can be located in a state only through arbitrary rules that can vary from state to state. Even worse, under the existing doctrines intangible property can be simultaneously present in more than one state, which can easily lead to multiple taxation.

Consider, for example, a state that treats a corporation's partnership interest as being sitused at the corporation's commercial domicile. That state will tax any income received from the partnership. If a state like Kentucky were to tax the same income on the theory that it had its source in Kentucky, double taxation would result. Both states would be imposing a fairly apportioned, internally consistent, nondiscriminatory tax, so that it is not obvious whether either would have the responsibility for eliminating the resulting double taxation.

As another example, consider a corporation that licenses the use of a trademark from L, the licensor. L is incorporated in State I and has its commercial domicile in State C. The corporation agrees to pay a royalty for every good it manufactures and sells bearing L's trademark. Assume the taxpayer manufactures the goods in State M, and sells the goods in State S.

Appendix H

Suppose that state M considers the license to be located in the state of manufacture, that State S considers the license to be located in the state in which the goods are sold, that State C considers the license to be located at the licensor's commercial domicile, and that State I considers the license to be located at the licensor's state of incorporation. Under a metaphysical presence standard, L--the licensor--would have nexus with States M, S, I, and C. The same royalty payment would be taxed by each of these states, resulting in multiple taxation.

As a final example, suppose an out-of-state vendor incorporated in State I, having its commercial domicile in State C, sells machinery to a corporation on an installment obligation. The sale is made in State S but later the customer removes the good to State R. Assume the vendor maintains a security interest in the good, which is filed in State R. The customer is incorporated in State D.

State S considers the installment obligation to be located in the state of sale, State R considers the obligation to be located where the security interest is filed State D considers the obligation to be located at the payor's state of incorporation, State C considers the obligation to be located in the state of the payee's commercial domicile, and State I considers the obligation to be located in the payee's state of incorporation. Under a metaphysical presence standard, the vendor would have nexus with States S, R, I, and D. Income attributable to the installment obligation would

be taxed by each of these states, resulting again in multiple taxation.

6. Metaphysical presence cannot be easily or fairly administered as a nexus standard

Metaphysical nexus presents formidable administrative problems. An author receiving royalties from the sale of a book could be taxable in every state in which the book was sold. A television producer receiving royalties by a network for the use of a program could be taxable in every state in which the program was televised. An electronic data bank receiving payments for the use of its services could be taxable in every state in which its logo appeared on a computer screen. A start up company in Silicon Valley could be subject to tax in every state in which its software licensees operate. A bank purchasing mortgages could be subject to tax in every state in which the underlying mortgagors reside or in which the collateral were located. An athlete receiving royalties from the endorsement of a product could be taxable in every state in which the product was sold. A shareholder receiving dividends from a multistate corporation would be taxable by every state in which the corporation did business.

As these examples suggest, the compliance burdens for taxpayers and administrators would be immense under a metaphysical presence rule. Individuals and small and medium sized businesses would be saddled with the obligation to comply with the tax laws of states with which they would have no familiarity. Administrative

considerations alone suggest that metaphysical presence is incompatible with the values and goals of the commerce clause.

7. The Commerce Clause Nexus Standard Should be the Same for Both Sales and Income Taxes

The U.S. Supreme Court has explicitly held that physical presence is the commerce clause nexus standard for sales and use taxes. Three policy considerations dictate that the same standard should apply for income taxes.

First, the commerce clause is concerned with the problem of multiple taxation. Yet the risk of multiple taxation is greater for income taxes than for sales and use taxes. In the case of the sales and use tax, typically there are only two states that can assert jurisdiction over the transaction: the state of origin and the state of destination. In the case of an income tax, however, a transaction may have contacts with numerous states, as the examples above illustrate. No reason exists to think that the Supreme Court is less concerned about multiple taxation when it occurs in an income tax than when it occurs in a sales tax. The same reasons that led the Court to endorse a physical presence standard for sales and use taxes apply even more strongly in the case of an income tax.

Second, treating income taxes the same as sales and use taxes is not only consistent with the policy values underlying the commerce clause, but also with the

language of the clause. Nothing in the language of the commerce clause refers to specific taxes. There is not one commerce clause for sales and use taxes and another for income taxes. No reason exists, therefore, for a state to develop a different (and lower) nexus standard for income taxes than for sales and use taxes.

Third, the orderly development of the law requires that the same nexus standard should apply to both income taxes and sales and use taxes. If metaphysical presence were to apply to income taxes and physical presence to sales and use taxes, confusion would undoubtedly result because two bodies of doctrine would simultaneously develop side-by-side.

Consequently, policy considerations, the language of the Constitution, and the orderly development of the law require that physical presence be the nexus standard for both income taxes and sales and use taxes.

Conclusion

The Revenue Cabinet is attempting to impose nexus on an out-of-state corporation that does not have any property or payroll in Kentucky. The Revenue Cabinet is treating the out-of-state corporation as having nexus in Kentucky because it has a partnership interest in a partnership that does business in Kentucky. In effect, the Revenue Cabinet is imposing a metaphysical presence standard by attempting to tax a corporation that has an intangible interest in another entity doing business in Kentucky, just like a shareholder has in a

corporation doing business in Kentucky. Its theory is apparently that an interest in a partnership that has nexus in Kentucky creates nexus for those that have an interest in the partnership. In effect, the Cabinet is applying a metaphysical presence nexus standard.

By any principled measure of comparison, physical presence is to be preferred to metaphysical presence as a nexus standard. Physical presence is more consistent with a bright line test, more consistent with settled expectations, more likely to reduce litigation and foster interstate investment, less likely to discriminate against the service sector, less likely to lead to multiple taxation, more easily administered, and more compatible with the growth of electronic commerce.

The Constitution does not distinguish between sales and use taxes and income taxes: there is only one nexus standard and the U.S. Supreme Court has endorsed physical presence.

The country has little experience with administering a metaphysical presence standard; the concept is amorphous and easily malleable. Metaphysical presence is less a legal principle and more an invitation to chaos and multiple taxation, thus undercutting the very goals of the commerce clause that the concept of nexus is intended to further.

APPENDIX I — EXPERT OPINION OF PROFESSOR RICHARD D. POMP, A POLICY ANALYSIS OF THE TAXATION OF OUT-OF-STATE CORPORATE PARTNERS

I. Introduction and Overview

In an earlier report, I discussed the policy considerations that should control the taxation of an out-of-state corporation having no property or payroll in Kentucky, which is a partner in a Kentucky partnership. The Kentucky partnership has nexus with Kentucky by having both payroll and property in Kentucky. The out-of-state corporation is a passive investor in the partnership, much the way a shareholder is a passive investor in a corporation. In general, a partnership and a corporation are both organized under state law pursuant to their own articles of organization and operating agreement. The out-of-of state corporate partner has no control of the partnership's assets, just like a shareholder in a corporation has no control of the corporation's assets. The partner is separate from the partnership for purposes of employer identification numbers, information statements, licenses, payroll taxes, withholding taxes, insurance coverage, trademarks, and qualification to do business, just the way a shareholder is separate from the corporation.

Viewed in this manner, the out-of-state corporate partner should not be considered as having nexus with Kentucky. I set forth numerous policy reasons in my earlier report about why Kentucky should not be seeking to tax persons that do not have a physical presence of their own with Kentucky. A passive investor

in a partnership should not be considered as present in Kentucky merely because the partnership in which it has an interest is doing business in Kentucky.

You have now asked me to state what happens if my preceding views have been rejected and the out-of-state corporation is characterized as having nexus with Kentucky. You have asked me from a policy perspective how the out-of-state corporation should now be taxed.

II. Analysis

If, contrary to the position of the Revenue Cabinet, the out-of-state corporation is not viewed as a passive investor in a partnership receiving income from intangible property, then it should be viewed as participating in the business of the partnership, sharing the capital, property, payroll, receipts, and profit (or loss).

Accordingly, the out-of-state corporate partner should apportion its share of the partnership's income. The factors of the partnership should flow through to the corporate partner in the same ratio that the income of the partnership flows through. Once the view is rejected that the corporate partner is an investor in the partnership, then it should be viewed as an active participant in the business of the partnership and apportion its income accordingly.

Put differently, there are two different paradigms that can apply to out-of-state partners in a Kentucky

partnership. The first is to characterize the partner as an investor, much like a shareholder in a corporation. Under that paradigm, long-standing and well-settled policy considerations dictate that Kentucky should not be able to tax the out-of-state partner if it has no physical presence of its own with Kentucky. Contrary to the position of the Revenue Cabinet, the physical presence of the partnership should not be attributed to the corporate partner.

The Revenue Cabinet is inconsistent in the way it treats investors in Kentucky partnerships and shareholders in Kentucky corporations. The Revenue Cabinet is seeking to tax the former but not the latter. The Revenue Cabinet has never taken the position that the physical presence of a traditional corporation should be attributed to its shareholders.

The Revenue Cabinet is also inconsistent in how it treats one type of partnership—a joint venture—from all other types of partnerships.[1] The receipts, property, and payroll of a joint venture flow through to the partners.[2] In other types of partnerships the Revenue Cabinet

1. Sections 761(a) and 7701(a)(2) of the Int. Rev. Code of 1986 provide that "the term 'partnership' includes a . . . joint venture . . . " "[T]he term 'partner' includes a member in such . . . joint venture . . ." Sec. 7701(2). Kentucky has adopted the federal tax code.

2. Kentucky Revenue Cabinet Tax Policy No. 41P200 (6/1/83).

treats the income as income from intangible property. This different treatment elevates form over substance,[3] which violates one of the most basic of income tax policies.

There is yet a final reason to reject on policy grounds the State's treatment of out-of-state partners. Kentucky apportions the income of an out-of-state partner based on the ratio of gross receipts from sales to purchasers or customers in Kentucky or services performed in Kentucky to the total gross receipts from sales or service everywhere.

From a policy perspective, such a result is clearly inferior to allowing the receipts, property, and payroll of the partnership to flow through to the partners. In the case before the Board, which led to the questions I have been asked to address, the partnership that manufactures and markets tobacco products. Both labor and property contribute significantly to the production of such income. Using only the sales of the partnership to apportion income is to disregard two significant business inputs: capital and labor. From a policy perspective, a formula that better reflects how income is generated by taking into account property and payroll is preferable by and large to one that takes into account only sales and ignores two key business inputs.

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3. Accord, Mark F. Sommer, Kentucky's Distinction Between Multi-State Income from Partnerships and Joint Ventures, 11 J. of State Taxation 26 (1992).

Appendix 1

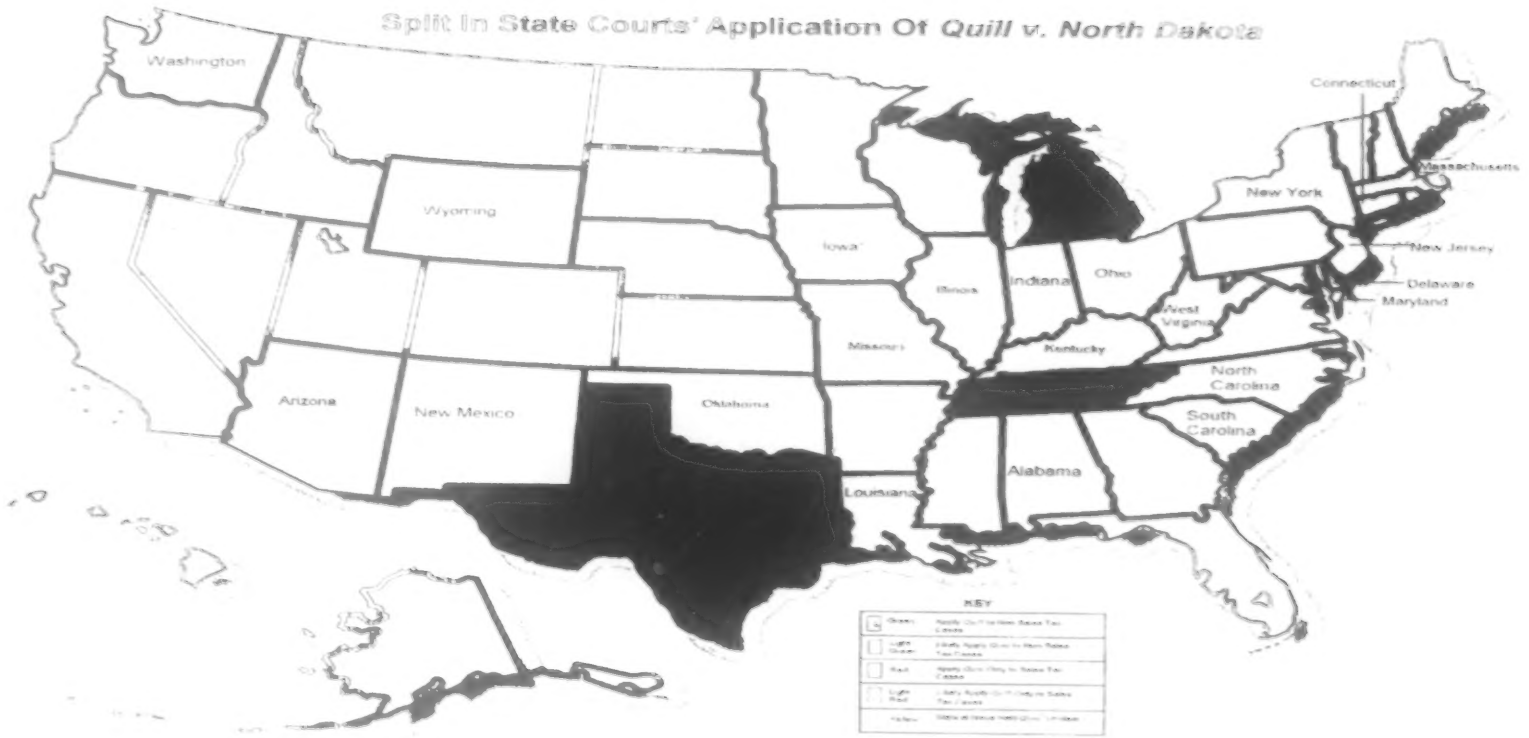
III. Conclusion

An out-of-state corporate partner that is a passive investor in a partnership should be treated the same as an out-of-state shareholder in a corporation. Such a partner should be viewed as separate from the partnership just the way a shareholder is viewed as separate from a corporation. The activities of a traditional corporation are not attributed to its shareholders; similarly, the activities of the partnership should generally not be attributed to its partners. Consequently, an out-of-state partner that has no property or payroll of its own in Kentucky should not be viewed as having nexus with Kentucky just because the partnership has property or payroll in the State.

If this view is rejected, the partner should be viewed as participating in the business of the partnership, sharing the capital, property, payroll, receipts and profit (or loss). Accordingly, the out-of-state corporate partner should apportion its share of the partnership's income. This approach is consistent with the way the Revenue Cabinet treats one type of partnerships—joint ventures.

In apportioning the income of a partnership that manufactures and markets tobacco products, both labor and capital should be taken into account. Both contribute significantly to the production of income. An apportionment formula should reflect the way in which income is generated.

Appendix J


Split In State Courts' Application Of Quill v. North Dakota
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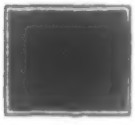

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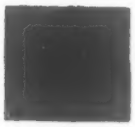

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